

# **Social Intermediation and Microfinance Programs:**

## **A Literature Review**



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### **MICROENTERPRISE BEST PRACTICES**

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# Social Intermediation and Microfinance Programs: A Literature Review

by

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## EXECUTIVE SUMMARY

The purpose of this literature review is to lay out what is currently known about the characteristics of and approaches to social intermediation as it is applied to microfinance development and programs, the rationale that practitioners provide for implementing these services, the range of goals established, and the methodologies applied. The paper also addresses key factors associated with effective performance and current thinking on cost and sustainability issues. It concludes with a discussion of substantive issues confronting the field and recommendations for future research on this important topic.

Social intermediation has been defined as a process in which investments are made in the development of both human resources and institutional capital, with the aim of increasing the self-reliance of marginalized groups, preparing them to engage in formal financial intermediation. A shorthand definition would be that social intermediation is financial intermediation with a capacity-building component, aimed at those sectors of society that lack access to credit and savings facilities.

Social intermediation involves the building of social capital in the form of groups that can generate an “information asset” for their members, allowing financial organizations to develop confidence in establishing a lending relationship. It transforms “beneficiaries” into “clients” through the development and enforcement of contracts between lender and borrower, and through the support for ownership and control over resources by the poorest. It leads to the establishment of systems and structures in which one or more institutional players create a sustainable process that successfully links poor borrowers to sources of capital and financial services, both credit and savings. Within such a system, social intermediation elements may be subsidized for a limited time period, whereas financial intermediation is expected to achieve self-sufficiency.

Institutions use a variety of strategies to support social intermediation. The choice an institution makes depends on its vision for the groups its supports: will they build and control their own financial assets; how much autonomy in decisionmaking will they have? It also depends on whether the organization believes that its clients require organizational inputs alone, or whether these must be joined to other services — in literacy and health, for example — so that they can take advantage of financial intermediation most effectively. Choice of strategy, finally, depends on whether the organization sees its role as promotional — organizing groups and linking them to formal sources of credit — or as providing credit and savings services directly. The terms “linking” and “parallel” are associated with these two options.

A linking strategy may involve one institution providing the social intermediation services (such as a nongovernmental organization [NGO] or, less frequently, a government agency), linking the organized poor to a mainstream bank or other formal financial institution providing the financial intermediation services. Experience with linking strategies is not well documented, and does not provide as many examples of successes as parallel models. Although there are certain advantages to a linking strategy in contexts where the financial structure appears well developed, it also carries with it several disadvantages. It requires that the social intermediary be able to overcome the very barriers that have kept the poor out of the system in the past; it also requires that they understand and enforce financial discipline on their clients and on themselves. Case examples from Asia show that this has been a problem for some implementers.

“Parallel” systems are so-called because they create alternative financial systems to the formal ones. Parallel models, often group-based, are well documented, and cover a number of well-known organizations as well as some lesser-known ones. These include solidarity group, village banking, and savings and credit cooperative models (which comprise self-help groups or SHGs). These group-based models differ in the complexity of roles they expect their clients to play, the level of autonomy in decisionmaking they engage in, and the amount and type of resources that clients manage. The first two models are credit-led, while the last is savings-led, which also implies a difference in the financial intermediation structures.

Effective social intermediation strategies have many features in common. They seek to design products and services that target the poorer sector of society; and they expect their clients to recruit and select each other into the program. They view their relationship with their clients in contractual terms, where each side has responsibilities and roles to play and accountability is mutual. They provide organizational development assistance directed at creating structures for joint liability, loan screening and administration, and, in many cases, the management of locally generated savings as well as external loans. They take a businesslike approach to their operations and are committed to financial sustainability.

Group-based models also have much in common. They seek to create homogenous groups in terms of the socioeconomic level of the participants. They also seek to find a group size that allows the peer mechanism to function, and at the same time provides administrative benefits. For some programs, this has meant developing a two-tier structure that incorporates smaller groups within a larger “center.” They implement methods that foster discipline, routine, and simplicity in the group’s tasks, and that provide transparency in financial transactions. As part of the development of management skills, effective programs develop methods of “risk phasing” that allow programs to build capacities as well as test clients’ integrity in a way that reduces the hazard for each side.

Many programs seek to incorporate broader dimensions of social and economic development within their activities, although how this is done varies immensely. For some programs, it involves the inculcation of key messages, like Grameen’s 16 Decisions; for others, it involves explicit add-on social services; yet others offer optional business development training, or allow the group process to lead spontaneously to other community activities. In all cases the imperative is to find ways to generate high input with low cost.

One of the more important and challenging components of effective social and financial intermediation systems is savings. They serve many purposes: to demonstrate discipline and commitment; to serve as insurance against default; to build a group-based capital asset, and, for some programs, to develop a source of loan capital for the institution itself. Savings services also respond to a felt need on the part of many clients. Some observers have also linked the use of savings (internal funds) for lending — as opposed to external funds — with accountability and performance. The source of funding becomes more important the more strongly the system is tilted to building autonomous, popularly controlled systems of financial intermediation.

Parallel, group-based systems have demonstrated that they can serve large numbers and also achieve relatively high rates of cost recovery. At the very least, several have demonstrated that they can achieve operational self-sufficiency, although their ability to achieve financial self-sufficiency is still being tested. They have achieved relative levels of efficiency in administrative costs, although this does not mean that the costs are low compared with formal institutions. Compared with individual-based lending models, they require greater transaction costs for their borrowers. However, their interest rates tend to be lower, thus



compensating one expense with a reduction in the others. Compared with direct bank-borrower relationships, they demonstrate strong financial advantages for both the banks and the poor borrowers.

The literature suggests several critical issues for these programs: structural elements in the group mechanism, and sometimes in the program, reduce access for the poorest; there is some suggestion that additional design mechanisms, such as consumption loans, easier entry hurdles, group controlled resources, and performance incentives geared to social development objectives, are needed to complement the peer mechanism. The effectiveness of the peer mechanism in ensuring repayment can also not be assumed. Much of its impact (positive or negative) depends on the details of how it operates, as well as in the way the program itself promotes these groups and establishes and enforces ground rules. There is some question as to the extent to which these methodologies support women's empowerment as well. Although a body of evidence exists that documents some significant change in women's self-perception, confidence, and roles, there is also countervailing evidence from Bangladesh that suggests that the mere provision of loans to women does not guarantee their economic empowerment.

Practitioners have serious challenges to address in building local organizations with strong accountability and control mechanisms. These require more training and organizational development assistance than a simple set of early promotional meetings. Practitioners are also challenged to address the implications of client dropout rates, because membership turnover may be a symptom of a variety of program issues, including exclusion of the poorest.

Finally, at least one set of observers has questioned whether group-based models are necessarily required to link the poor to financial intermediation. Well-designed individual programs that include intensive loan collection, savings and insurance facilities, and incentives to repay may function effectively as well. However, those who are concerned not only with issues of financial access, but also with issues of social development, and, in particular, with the building of autonomous, self-reliant organizational structures owned and managed by the poor, feel that there is no substitute for the power of group models, especially for those who have been so often excluded from financial services in the past.

## INTRODUCTION

Group-based financial service models have captured the attention of development practitioners around the world. From Bangladesh to Bolivia, from Kenya to the United States, group-focused credit and savings programs have blossomed, all with the vision of reaching the poorest of the economically active with financing that can lift people out of poverty by building businesses, generating assets, and strengthening skills. In many cases, these systems have flourished even when the overall performance of the economies in which they operate is so weak that formal institutions have faced insolvency.

Group-based programs have emerged, first and foremost, as a mechanism to allow the poor access to financial services that they have historically been denied. Such programs have multiplied rapidly because they have demonstrated their capacity to reach large numbers of those in need with small, short-term loans suited to their economic activities, to foster high repayment rates, and to mobilize significant amounts of savings. Development practitioners interested in social development have also noted their apparent capacity to empower the most vulnerable, especially women; to allow the not-yet-economically-active to become so; and to create community-based structures that build mutual support and trust.

The “group” element of microfinance has become such a central aspect of practice that it has been recognized by some as a methodological component equal in weight to the actual exchange of finance. Labeled “social intermediation,” to reflect a parallel concept to financial intermediation, the organization of groups to mediate financial and social services to members is seen as an essential part of the microfinance process directed to the poor. It enables the poor to bridge a daunting series of barriers that have kept them outside the financial system — barriers that are at once physical, economic, and social. Social intermediation achieves this by creating social capital that compensates for their lack of material assets. In turn, this investment in social capital creates creditworthy borrowers where none existed before, and supports financial investments in their economic activities.

Yet group-based models are not without imperfections — and their critics. Some researchers have recently questioned the extent to which these programs live up to the rhetoric that surrounds them, raising questions about depth of outreach, the limits of their ability to enforce repayment, and the intensity of empowerment effects. Others have noted the administrative and time burdens placed on the poor — and on the microfinance institutions as well. Many have been observed, for example, to collect individual client data, and do individual follow-up, leading to administrative cost rates equal to that of individual lending programs. Although only a limited amount of research raises these questions, such inquiries have thrown new light on the nature of social intermediation in practice, challenging some of the field’s accepted orthodoxy regarding these social processes.

The purpose of this literature review, then, is to provide a context in which to understand these different perspectives. Drawing on general works on microfinance methodology and on specific case studies, the report will lay out what is currently known about the characteristics of and approaches to social intermediation, elaborate the rationale that practitioners provide for implementing these services, the range of goals established, and the methodologies applied. Key factors associated by many observers with effective performance will be outlined along with current thinking on cost and sustainability issues. The paper will conclude with a discussion of substantive issues confronting the field and recommendations for future research on this important topic.

Social intermediation is a significant element of microfinance programming. Yet in the literature reviewed — besides the significant body of material drawn largely from the World Bank’s Sustainable Banking for the Poor project — there are surprising and significant gaps in this topic.<sup>1</sup> The three other categories of documentation reviewed were solidarity group and village bank materials, which capture in fairly broad ways the features of these models and the experience that some organizations have had using them; a series of case studies on microfinance programming, which deal mostly with larger themes of institutional and financial sustainability, program operations, and outreach — where social intermediation, if mentioned — is only mentioned indirectly; and, finally, general microfinance literature that addresses issues of theory and practice.

Few works take an in-depth, empirical look at the most crucial aspects of the social intermediation process — such as how peer pressure functions; the nature of self-selection in groups; and the actual costs incurred (including subsidies) of building effective social organizations. The documents do, however, convey a sense of the power of the process when done well and the issues that practitioners and researchers are raising in their attempt to learn more about effective microfinance programming. For those people who recognize social intermediation as a concomitant process to that of financial intermediation, much work still has to be done in completing the picture and for creating a road map to better practice.

## **DEFINITIONS AND KEY ELEMENTS**

Social intermediation has been described most extensively in the microfinance literature by Lynn Bennett and her colleagues in the World Bank’s Sustainable Banking with the Poor project. As they define it, social intermediation is a process in which investment is made in the building up of both human resources and institutional capital, with the aim of increasing the self-reliance of marginalized groups, and preparing them to engage in formal financial intermediation.<sup>2</sup> It is “special efforts to integrate poor men and women into formal financial markets and link them to government services that may help them to become more productive and able to lead more satisfying lives. . . . It is niche marketing, attempting to create systems and products for people who do not normally interact with formal financial institutions because of illiteracy, lack of assets, gender or ethnic background. It seeks to create new attitudes and self-perceptions as well as new systems and institutions to build self-reliance, confidence and empowerment.”<sup>3</sup> Social intermediation has three significant components:

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<sup>1</sup>World Bank authors include Lynn Bennett, Michael Goldberg, Pamela Hunte, and Carlos Cuevas. They have written conceptually about social intermediation, mostly in the Asian context.

<sup>2</sup> Lynn Bennett, 1996a, “Social Intermediation: Building Systems and Skills for Sustainable Financial Intermediation With the Poor,” Washington, D.C., The World Bank’s Sustainable Banking with the Poor project, Rural Finance Seminar, May 1.

<sup>3</sup> Lynn Bennett, Michael Goldberg, and J. D. Von Pischke, 1994, “Basing Access on Performance to Create Sustainable Financial Services for the Poor in Nepal,” Washington, D.C., World Bank’s Sustainable Banking with the Poor project, paper prepared for a conference on Financial Services and the Poor at The Brookings Institution, September 22.

- Building of social capital;
- Transformation of “beneficiaries” into “clients” (or “customers”); and
- Creation of local institutions that bridge the gap between the formal financial institutions and marginalized groups.

Each component is discussed below.

## **Building Social Capital**

The concept of social capital is perhaps the key theoretical element in social intermediation, and has been borrowed from the anthropological and sociological literature. Social capital surfaces for anyone seeking to address the question, to what can we ascribe successful microfinancial systems?

J.D. Von Pischke points out that finance is primarily social, that the Latin root of “credit,” *credere*, is to believe or entrust.<sup>4</sup> Financial intermediation depends upon trust between the borrower and the lender that contracts will be honored.<sup>5</sup> Historically, the basis for that trust has depended on two critical elements — the applicant’s reputation as a person of honor and the availability of collateral against which claims can be made in case of default. The first element, reputation or character, was assessed based on the lender’s intimate knowledge of the borrower, or, failing that, on the witness of other reliable persons and a documented history of past borrower behavior. But these are the two elements that formal lenders find lacking among the poor — they are not known to the lender in any profound way, nor do they have material value to pledge against risk. Added to these two barriers are others that further increase the distance between lender and borrower. They may be policy and institutional barriers; they may be physical, such as poor infrastructure, remote difficult terrain, and, often, stagnant subsistence economies where there are few opportunities for successful businesses, or they can be socioeconomic, such as illiteracy, caste, and gender.<sup>6</sup>

The consequence of these barriers is that the lender perceives the administrative costs of gathering information and processing applications for poor people as too costly relative to the small size of the loans and the potential profit. Something needs to be created to overcome these barriers, and that something is social capital.

Social capital was defined by Putnam as, “those features of social organization such as networks, norms and trust that facilitate coordination and cooperation for mutual benefit. Social capital enhances

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<sup>4</sup> J. D. Von Pischke, 1991, *Finance at the Frontier: Debt Capacity and the Role of Credit in the Private Economy*, Washington, D.C., World Bank, p. 41.

<sup>5</sup> Bennett, 1996a, p. 3.

<sup>6</sup> Ibid., p. 2.

the benefits of investment in physical and human capital.”<sup>7</sup> The first element given in this definition, “networks, norms, and trust,” was further defined by Frances Fukiyama as “local clubs, temple associations, work groups and other forms of association beyond the family and kinship group,” and also “large, publicly owned corporations.” They are important for one key reason: “Because both civil and commercial associations which reach beyond the family depend on — and foster — traditions of collaboration and a certain level of trust between members of society, they are able to reduce what economists call the transaction costs of doing business in that society.”<sup>8</sup>

In traditional societies, forms of this social capital can be found in a variety of groups, differentiated by their inclusiveness (whether they cover the entire community or part of the community through self-selection), and by the type of activity for which members are willing to invest time, resources, and mutual guarantees. Forms of social capital range from bridge or community benefit organizations, where the commitment is labor; to burial societies, where there is some financial commitment, but the obligation is known, limited, and relatively small; to ROSCAs (rotating savings and credit associations), which involve ongoing financial arrangements. Each of these involves a different “contract” in the time and resource commitments involved and the permanence of membership. The number of individuals willing to move to the highest levels of financial obligation and continuity tend to be fewer in number.<sup>9</sup>

When access to financial intermediation services is the intent, it results in the formation of self-help groups that provide a new type of organization through which the poor can relate to others in society, and through which members can develop a substitute for the collateral they lack. That substitute, the peer guarantee mechanism, introduces shared liability and pressure from social groups as a replacement for security and business appraisals. In addition, this mechanism offers a vehicle for slashing administrative costs of the formal lender. Costs to lenders are reduced in gathering information about borrowers, and lenders can shift onto groups some of the loan-processing and loan-approval tasks. Shared liability and the promise of repeat loans in increasing amounts was also recognized as a key factor in motivating repayments.<sup>10</sup>

In effect, the self-help group — called a solidarity group, a village bank, a savings and credit cooperative, or some other name — creates an “information asset” for the poor. That information asset is first and foremost the collective endorsement of character that each member of the group provides the other, which is accepted by the financial intermediary in lieu of other assets. Second, it is the knowledge that each member has of each other’s economic activities (and household situation), which supports an accurate assessment of ability to pay. Then,

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<sup>7</sup> Lynn Bennett, 1996b, “Microfinance and the Creation of Social Capital,” Sustainable Banking with the Poor project, ASTHR, The World Bank, October 9, p. 1, cites Robert D. Putnam, “The Prosperous Community: Social Capital and Public Life,” in *The American Prospect*, No. 13, Spring 1995, pp. 35-36.

<sup>8</sup> Bennett, p. 2.

<sup>9</sup> Michael Goldberg, 1998, Memo on Social Intermediation, February 8.

<sup>10</sup> E. Rhyne and M. Otero, 1994, *The New World of Microenterprise Finance: Building Healthy Financial Institutions for the Poor*, pp. 15-16.

If the group is strong, one with good records and clear contracts, it will create a credit record for the individual against which that individual can borrow for both consumption smoothing and small productive loans. If all the members together create a positive credit record for the SHG [self-help group] as an institution, then they are creating an even bigger information asset which they should eventually be able to leverage to get access to the formal banking system and the larger amounts required to purchase assets that can significantly boost their productivity and incomes.<sup>11</sup>

Yet even if societies are “rich” in social capital endowments — in other words, well-functioning mechanisms for mutual cooperation — there is still no guarantee that banks or other formal financial institutions will recognize, cooperate, or work with groups of marginalized men and women. Further transformation has to occur within groups, which leads to the second major component of social intermediation.

### **Transforming Beneficiaries into Customers**

Creating an information asset is only the first part of developing a financial relationship. The second part is developing the capacity of the poor, in using that asset, to establish and maintain a reciprocal contractual relationship around the transfer of funds. Not all poor people are ready for this second step without first receiving some capacity-building assistance. Certain actions must be taken to build the technical capacity of group members in a variety of ways. Bennett maintains that instead of microentrepreneurs remaining “beneficiaries” of program services, they must become “customers” able to pay market rates for services.<sup>12</sup>

This transformation often occurs in two steps. The first may involve using groups to expand access to social services (like health, adult literacy, and family planning), and production support services, like agricultural extension, if needed. The second step, and most critical one for financial intermediation, involves training members in participatory management, accounting, and basic financial management, and helping groups establish good record and audit systems so they can “keep score.”<sup>13</sup> Lending to beneficiaries (a “one-way flow”) in the past has resulted in poor repayment discipline, because loans made in this context tend to be perceived as grants — if donor grants or government subsidies stop, the groups generally collapse. A “two-way flow” of obligations allows poor people to escape from dependent relationships and to create a foundation for sustainability. It prepares them to enter into solid business relationships with formal financial institutions — or to create their own.”<sup>14</sup>

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<sup>11</sup> Bennett, 1996a, p. 9.

<sup>12</sup> Ibid., p. 4.

<sup>13</sup> The requirements and extent of participatory management vary with the type of group organization and with the stage of the group’s formation. At an early stage, members may tend to engage in a limited number of decisions, such as criteria for membership, and allow strong leaders to set the balance of the agenda. As experience is gained, members may insert themselves into a broader range of decisions (Goldberg, 1988).

<sup>14</sup> Ibid., p. 4.

## Creating Local Systems and Structures

Bennett maintains that successful microfinance efforts (particularly those working through groups), which seek to create sustainable access to financial services for microentrepreneurs, actually create locally controlled systems that bridge the gap between formal financial institutions and the poor.<sup>15</sup> These systems include institutions that work together to deliver social and financial intermediation services to the poor. In some instances, the system may consist of one organization that delivers both types of service, with the clients organized into some form of self-help groups with varying degrees of autonomy and control. These systems are called parallel systems because they create alternative financial systems to the formal ones.

In other cases, the system may involve one institution providing the social intermediation services (such as a nongovernmental organization [NGO] or, less frequently, a government agency), linking the organized poor to a mainstream bank or other formal financial institution providing the financial intermediation services. These latter systems are called linking approaches because they seek to bring the formal and informal sectors together. These systems operate differently, have different cost structures and sustainability paths, and contain actors with different missions. When outside observers analyze linking systems, it becomes important to understand and appreciate how these various elements play out. From Bennett's perspective, misunderstanding the full complexity of roles in social and financial intermediation has led too often to a lack of appreciation of the social intermediation half of the system. The problems are multiplied by an insistence that all actors become self-sufficient, whether their role is to intermediate finance or not. In the multi-institutional systems where NGOs play only the social intermediation role, this insistence is misplaced.

## Other Theoretical Underpinnings

The practice of social intermediation has also drawn theoretical — and experiential — strength from other sources. Four of these are summarized by Berenbach and Guzman:

- “Group lending methods, which are at the heart of these approaches, ‘draw heavily’ on the experience of traditional ROSCAs, . . . in which participants contribute regularly to a common pool which each member then draws [from] in some turn, often by chance. These informal associations are highly effective mechanisms for gaining access to capital, based as they are on interpersonal ties and mutual obligations. These features are picked up in solidarity groups, village banks and other self-help groups, but with a difference: members can control the timing of the loan so that they may obtain financing when their business can best use it. Members are not obliged to divert a significant share of the loan to meet hospitality obligations. . . . Further, members need not risk the group disbanding midway or a group member misappropriating funds.”<sup>16</sup>

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<sup>15</sup> Bennett, 1996b, p. 3.

<sup>16</sup> Sharon Berenbach and Diego Guzman, 1992, *The Solidarity Group Experience Worldwide*, Washington, D.C.: ACCION International, November, pp. 23-24.

- Group lending responds to the principal economic issues faced in the lending relationship: economies of scale, imperfect information, and accountability. The clustering of small loans and group administration resolves the first economic dilemma; the peer guarantee and self-screening allow lenders to “benefit from intra-group familiarity with their members’ likelihood to default.” And accountability is managed by peer monitoring, incentives for repayment and group-based enforcement procedures when the borrower fails.
- Peer group lending also draws from the experience of the moneylender. Small, short-term financing is offered using similar methods of character guarantees, agile screening practices, and immediate disbursements. The difference is in the interest rates charged which are usually significantly less.
- Finally, group based models share a similar perspective as institutional economics, which addresses the effect of behavior and attitudes on economic relationships. Citing the work of Floro and Yotopoulos, the authors point out that where commercial institutions are largely underdeveloped, personal relations (family or community ties) hold precedence over legally proscribed covenants such as formal loan agreements. In that sense, a borrower is more likely to respond to the mutual guarantee obligation in a peer group lending arrangement than to a legally binding credit agreement signed with a public agency.<sup>17</sup>

All these perspectives have influenced the evolution of social intermediation strategies. In addition to social capital theory, they further demonstrate why these approaches have gained such a following within the field of microfinance.

### **INSTITUTIONAL GOALS, STRATEGIES, AND ROLES IN SOCIAL INTERMEDIATION**

When one looks at the field of microfinance, the pervasiveness of social intermediation strategies is apparent. Most of the well-known programs — Grameen Bank, the Bangladesh Rural Advancement Committee (BRAC), BancoSol, Kenya Rural Enterprise Programme (KREP), and others — and many less-well-known ones, are engaged in one form or another of group-based organization, skills building, and financial services. But within this array of programs lies a rich variation in methodologies and emphases. These differences emerge from several factors: the vision the institution has for social intermediation and the goals it sets for its activities as a result of this vision; following from this, the organizational models and services it chooses to offer; and, finally, the structure or system that will serve as the context for the program, to enable the institution to determine what is required and what it is best placed to offer in that setting. Following are illustrations of each of these factors.

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<sup>17</sup> Ibid., pp. 24-27. For their discussion on institutional economics, Berenbach and Guzman draw on the work of S. L. Floro, and P. A. Yotopoulos, 1991, *Informal Credit Markets and the New Institutional Economics, the Case for Philippine Agriculture*, Boulder: Westview Press.



## Visions and Goals

The previous chapter presented a description of social intermediation that emphasizes the human-resource-development aspects of the process, and the build-up of skills of individual members as well as of organized groups. As organizations have set about this process, there have been differences in emphasis that color how they set about organizing and servicing groups, and the choice of ends to which the process is directed. This difference is demonstrated in the extent to which the institution sees its role as creating a credit delivery mechanism, as creating community-controlled financial institutions, or as supporting a more broad-based social and economic entity.

If the goal is to create a credit delivery mechanism, the focus is on fostering small, mutual guarantee solidarity groups with limited roles. Although the solidarity group program provides the institutional means through which communities can organize themselves toward mutual self-help to achieve other social and economic ends, this is not a necessary, or organizationally facilitated, component of the process. ACCION International and its affiliates represent this approach.<sup>18</sup>

If the goal is to create community-controlled financial institutions, the focus is on creating local financial structures with autonomy in loan decisions and management. This vision emphasizes greater ownership and control for the groups than the solidarity group approach, and includes the expectation that local groups will manage their own loan fund pools. Village bank programs, such as those supported by FINCA International, are a prime example of how this vision is implemented. Although greater emphasis is placed on building autonomous financial structures, it is still anticipated that banks will remain linked with the program, rather than that the program become fully independent.<sup>19</sup>

If the goal is to support a broad-based social and economic entity, the vision is articulated as the creation of people's organizations that can become permanent economic structures for greater economic security. Under this perspective, many of the aspects of the process are the same, and they develop collective assets. These assets, however, are not only the information asset of reputation, but also negotiating power, and, tangibly, economic security services such as insurance schemes, productive facilities, storage facilities, and market services. The purpose is the creation of access to markets, information, technical know-how, and social support services, all of which will be as important as money if the poor are to share in economic growth. The Self Employed Women's Association (SEWA) is most closely associated with this perspective.<sup>20</sup>

## Organizational Models

The community-level organizational model promoted by the institution is closely associated with its vision. For financial intermediation, the three principal models discussed in the literature are solidarity

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<sup>18</sup> Berenbach and Guzman, 1992, p. 62.

<sup>19</sup> John Hatch, R. Quiros, and E. Wehr, 1997, FINCA/Honduras' Model of Social Intermediation, unpublished draft paper, p. 2.

<sup>20</sup> Ela Bhatt, "The World of Work in the People's Sector and Its Inherent Strength: SEWA Experience," India: SEWA.

groups, village banks, and savings and credit cooperatives, also called credit unions. Although all offer a mechanism for the delivery of financial services, they differ significantly in such areas as membership, group structure, management, the joint liability mechanism, and the financial services offered. Table 1 summarizes their most distinctive features.

## Service Mix

As Bennett has noted, the range of social intermediation services ranges from the simple to the complex — from offering only those organizing and financial skills needed to become clients of financial intermediation to offering a range of social services that facilitate participants' development in broader ways. The sequencing of these services may also vary. In some settings, institutions may consider it necessary to offer access to basic social services (such as literacy training or health care) prior to or with the core management and accounting training needed for financial intermediation; in other instances, there is the belief that such services can be offered with greater impact and economies of scale after the credit and savings capacity has been built.

At least some observers also think that the combination of services has power in terms of ensuring repayment. Huppi and Feder (1990) have noted that groups may have a "further incentive to repay if a common interest other than credit is combined with other social services that enhance group accountability."<sup>21</sup>

Looking at it from the opposite perspective are those who focus purposely only on the core services required to transform beneficiaries into financial services clients, both because that is seen as the key to unlocking a whole process of transformation, and because it is believed that there is a need to specialize and develop expertise in this more narrow sector if any real impact is to be had. Berenbach and Guzman (1992) represent this perspective when they write:

Underlying the service mix debate . . . are classic organizational tensions related to specialization versus diversification. These issues are not specific to microenterprise programs and figure prominently in corporate strategic planning and organizational development literature. Common sense tells us that it is easier to do one thing well. The [solidarity group] programs examined have demonstrated that although at times in the organization's development it has been essential to concentrate on a single objective (such as credit delivery), once certain performance standards have been attained, the programs have been able to respond to diverse client needs. The correct balance of specialization versus diversification is specific to each organization, reflecting the existing organizational capacity, management talent, and the judgments of the board of directors that establish policy (p. 72).

Ultimately, what is important in determining whether to offer multiple types of services, over and above the needs of the client, is that the delivery of social services should not affect the businesslike contractual orientation of the core financial process. Of most critical importance is that there be transparency and accountability in the financial transactions associated with each side of the equation to ensure that the necessary rigor of self-sufficiency is heeded.

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<sup>21</sup> Berenbach and Guzman (1992) report this observation taken from M. Huppi and G. Feder, 1990, "The Role of Groups and Credit Cooperatives in Rural Lending," *The World Bank Research Observer*, Vol. 5, No. 2, July.

TABLE 1  
COMPARISON OF GROUP-BASED ORGANIZATIONAL MODELS

	Solidarity Groups	Village Banks	Cooperatives/Credit Unions
<b>Structure</b>	Small groups between 4 and 8; the Grameen Bank insists on 5; Grameen and its replicators also have second tier Center structure which brings together a number of these for the purpose of loan administration and education.	Medium size groups averaging 20 to 50; banks elect officers to lead and manage loan decisions and administration; some village bank programs have incorporated solidarity groups of 5-7 within the bank structure.	Large groups between from 50 to 200+; may be regulated (if credit unions) or unregulated, if self-help groups.
<b>Membership</b>	Varies; in Grameen Bank style programs, usually the poor at or below the poverty line and quite homogenous; in other programs, such as those associated with ACCION membership, may be lower income, but not necessarily the poorest, and groups may be heterogeneous.	Largely targeted to the poor at or below the poverty line.	Some observers report them to be more heterogeneous if they follow the savings and credit cooperative model of open membership; open bond membership covers geographic area rather than poverty level; other observers (Magill) indicate that while not the poorest, they are similar in assets, business size, and income to the micro and small scale business owners found as clients of ACCION affiliated programs.
<b>Lending Process</b>	Program makes one loan to solidarity group on behalf of individual members; initial loan is same size; may vary among group at later stages; group representative is responsible for disbursing the individual loans to its members and collecting it for repayment.	Program makes one loan to village bank which the bank management on-lends to members; initial loan size roughly equivalent to minimum monthly wage for day labor in area; subsequent loans depend on repayment, and size is linked to the amount of savings generated by borrowers during previous loan cycle.	Groups are savings led; members expected to buy initial shares and/or save a set amount before borrowing is allowed; loans made to individuals within the group based on their meeting these requirements and offering some form of collateral.
<b>What Groups Do</b>	Solidarity groups recruit and select their own members, guarantee each others' loans; disburse and collect payments; collect group savings and fees if there are any.	Village banks recruit and select their own members; establish by-laws and operating procedures in consonance with implementing agency guidelines; disburse and collect loan repayments; also collect required savings and manage them as an Internal account fund that may be deposited in a bank; or re-lent to members and outsiders; some of these funds may also be used for community purposes.	Self-help groups and cooperatives elect their own management; set interest rates and savings policies; manage lending activities.
<b>Guarantee Mechanisms</b>	Peer guarantee; some models require groups to collect group funds which can also serve to underwrite delinquencies and defaults.	Peer guarantee; internal account funds also serve as collateral against the full loan provided by the implementing agency.	Use savings on deposit as guarantee, as well as two or more co-signors (other group members) to support loan applications; may also accept physical guarantees, although most loans are character based.
<b>Transaction Costs for Borrowers</b>	High for models expecting weekly participation in center meetings; moderate for those models that do not require meetings, and expect member representative to collect and deliver repayments to the organization.	High as weekly or bi-weekly meetings required to make loan and savings payments.	Moderate, depending on the meeting requirements.
<b>Savings Policies</b>	Solidarity group programs are credit-led; may include forced savings requirements in the form of group funds and other insurance schemes.	VBs are credit-led but introduce forced savings as a means to build a group based financial asset that can be used for investment or as a guarantee of repayment of outstanding loans; an individual's access to these savings is usually curtailed until end of cycle or departure from the bank.	These models are savings-led; credit follows a period of savings and certain amount achieved; intention is to build full service financial member organization; initially most only forced savings; now many innovated to offer voluntary savings options as well as credit.
<b>Group Ownership and Control</b>	Solidarity groups are generally borrowing groups; decision making mostly refers to membership selection and willingness to support loan applications.	VBs expected to recruit select members; review and approve loans for both External and Internal loans, build internal capital, make investment decisions with those funds; originally expected to graduate, become independent, now expected to remain affiliated to the sponsoring program with greater ownership because of the capital build up.	SHGs/savings & credit cooperatives may be organized as independent institutions or affiliate as apex structures to provide greater liquidity management/management support. Local group manages own savings/loans, assumes strong fiduciary responsibility for safeguarding members' savings.

Sources: C. Nelson, B. McNelly, K. Stack, and L. Yanovitch, 1996, *Village Banking: the State of the Practice*, New York: SEEP and UNIFEM, pp. 10-30; Maria Otero, 1986, *The Solidarity Group Concept: Its Characteristics and Significance for Urban Informal Sector Activities*, New York: PACT, pp.1-22; Berenbach and Guzman, 1992, pp. 11-19; D. Hulme and P. Mosley, eds., 1996, *Finance Against Poverty*, Volumes 1 and 2, New York: Routledge, pp. 167-174; and J. H. Magill, 1991, "Credit Unions: A Formal Sector Alternative for Financing Microenterprise Development," GEMINI Working Paper No. 22, Bethesda, MD: Development Alternatives, Inc.

## Choosing One's Role in the System

As mentioned above, institutions engaged in social and financial intermediation need to determine whether they will provide both services directly — creating what Bennett calls a parallel system — or whether they will focus on social intermediation itself, linking clients to formal financial institutions. One of the most interesting conclusions that Bennett draws from her examination of a series of Asian programs is that there are many legitimate roles within a linkage system, and not all of them necessarily must be subsidy free. Particularly with NGOs in mind, she comments “that there are many valid roles for NGOs to play within a sustainable system of financial intermediation even if the NGOs itself is not able to become subsidy-independent in the way that a well-performing bank or cooperative can.”<sup>22</sup> Those roles may include providing the basic training and organizational development training to clients, initiating savings activities, possibly matching with some initial capital, and then linking the organized groups to a commercial or public bank. The critical feature here is that the NGO role must be seen as transitional and time-bound, with withdrawal scheduled as community-based groups and formal financial institutions establish solid and ongoing relationships.

Johnson and Rogaly identify some of these transitional roles in a system of social and financial intermediation:<sup>23</sup>

- Where ROSCAs do not exist or have limited coverage, NGOs can facilitate the formation of savings groups, or enable them to develop slightly more sophisticated systems of internal on-lending that allow savings and loans to take on more flexible formats. These groups can then link with formal financial institutions for additional access to capital, as required. Friends of Women's World Banking is cited as using this approach.
- NGOs may create linkages between local groups with pre-established credit unions or thrift and savings cooperatives. Freedom from Hunger (FFH) is pioneering such an approach in several of its West Africa programs, where FFH is responsible for organizing village banks to provide technical assistance to the credit union federation that will serve as the financial intermediary.

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<sup>22</sup> Bennett, 1996a, p. 5.

<sup>23</sup> S. Johnson and B. Rogaly, 1997, *Microfinance and Poverty Reduction*, Oxfam Development Guidelines, U.K. and Ireland: Oxfam, pp. 30-33.

- The NGO may organize local groups and help them gain access to formal banking services from the public or private sector. The National Bank for Agricultural Development (NABARD) in India illustrates this approach.<sup>24</sup>

The question is: how does an organization decide which role to play? Direct financial intermediation, or a brokering role? Bennett suggests that the brokering role seems to make a lot of sense in countries where the formal banking system already has an extensive presence in the rural areas, because it “essentially involves developing a new low-cost layer of intermediation reaching vast numbers of small rural savers and borrowers whom the banks could not afford to serve with their current branch-based technologies and rather limited product lines.” She further notes that this approach is used in Vietnam and “beginning to catch on in India.”<sup>25</sup>

There are several potential advantages to this approach, most related to the capacities that a formal financial provider brings to the table: a set of pre-existent branches, a system to maintain records and enforce repayment, voluntary savings services, and an experienced staff.<sup>26</sup> But there are also disadvantages as well. Bennett notes that linking systems may have to overcome gender, language, and ethnic barriers that existing formal-sector institutions present to target clients.<sup>27</sup>

In addition, the literature presents few successful examples of this type. Apart from NABARD, cited by Bennett above, there are two others, reported by Johnson and Rogaly — the partnership between the NGO Rangpur Dinajpur Rural Services (RDRS) and a set of four banks in Bangladesh, and the

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<sup>24</sup> “The National Bank for Agricultural Development (NABARD) runs a scheme to encourage banks to lend to mature SHGs, and NABARD recently reported that some 4,757 groups are currently linked to banks through this program and have received donor Rs. 60 million in bank loans. . . . For most SHGs, NGOs have played a key role in the initial organization of ‘affinity groups’. When the group has shown that it is able to manage its own internal fund (after several rounds of lending and repayment), and is ready to move on to larger loans for productive purposes, the NGO may provide a matching grant or loan to increase the group’s lending capital. If the group is able to handle this, the NGO then intermediates between a formal bank and the SHG to help them get a bulk loan or sometimes a credit line which they can then on-lend to their members. NABARD reports that on-time repayment to the banks that have lent to SHGs through its program is 100 percent.” (Bennett, 1996b, cites NABARD, “Project on Linking SHGs with Banks: Status as on March 31, 1996,” Bombay.)

<sup>25</sup> Bennett, 1996a, p. 6.

<sup>26</sup> Lynn Bennett, “The Necessity and Dangers of Combining Social and Financial Intermediation to Reach the Poor,” Chapter 6, book forthcoming, J. D. von Pischke, ed., p. 10.

<sup>27</sup> Ibid.

partnership between Oxfam Hyderabad and the Federation of Thrift and Credit Associations in Andhra Pradesh.<sup>28</sup>

In addition to these three case examples, the only other models discussed with any depth in the literature reviewed are Asian cases studied by Bennett, Goldberg, and Hunte.<sup>29</sup> MYRADA, the Mysore Resettlement and Development Agency in India, and SRSC, the Sarhad Rural Support Corporation in Pakistan, are variously described as linking models, but with some parallel elements. Data provided on each demonstrates that they are less than singular successes.<sup>30</sup>

Characterized as strong on outreach to the poor, they have done less well in developing the financial intermediation aspects of the system in a manner consonant with sustainability. The reasons for this failing were attributed to weaknesses in the group formation process. Bennett, Goldberg, and Hunte indicate:

There are four reasons for poor repayment performance for MYRADA . . . and SRSC groups. First, according to interviews with members, groups do not establish clear contracts or provide consistent information. A large share of the membership cannot give a specific repayment date or schedule. Second, groups do not enforce loans consistently and, in many cases, fail to establish the norm of on-time repayment. In addition, loans are designed inappropriately, failing to match local conditions and members' experiences. Finally, the NGO extensionist takes on a large role in choosing investments, shifting the responsibility of the outcome from the individual member to the NGO. This finding highlights the importance of member participation in the design and enforcement of contracts and selection of investment.<sup>31</sup>

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<sup>28</sup> RDRS promotes and trains groups to the point where the groups go to the banks for loans. The banks bear all the lending risk. Johnson and Rogaly (1997) report that 1,800 groups, of 10 to 20 members, have been trained, and "repayment is good. . . . The banks claim they are making a profit (of something like 6 percent on each taka loaned), whereas they make a loss on most of their normal business. About US\$1.8 million had been lent up to mid-1995." Oxfam Hyderabad is reportedly working with the Federation of Thrift and Credit Associations in Andhra Pradesh, encouraging exposure visits to flourishing thrift and credit societies by potential members from other areas. The members gain a source of consumption credit based on their own savings. Oxfam Hyderabad is reported to see its support for linking potential groups with an existing thrift and credit structure as a move away from direct funding of NGOs to provide credit (Johnson and Rogaly, 1997, pp. 31-33; Chauduri, S. A., 1994, "A Case for Bank Assurance in Rural Bangladesh," *Daily Star*, Dhaka [January]; and Oxfam [India] Trust, 1993, Paper to the India Policy Forum).

<sup>29</sup> L. Bennett, M. Goldberg, and P. Hunte, 1995, "Group Based Financial Services Models: Lessons from Five South Asian NGOs," talking notes for conference on "Finance Against Poverty," Reading University, Reading, March 27-28, United Kingdom.

<sup>30</sup> MYRADA, established in 1984, is reported to assist 19,763 members in 696 groups with group building, health, literacy, and agricultural extension. Borrowers link to the Tamil Nadu Women's Development Corporation for loans. Annual repayment rate is estimated at 54 percent. SRSC supports 5,388 clients in 154 groups, providing services similar to MYRADA and linking members to local banks. Estimated annual repayment rate is 52 percent, and administrative cost per dollar lent is reported at greater than 400 percent. Bennett, 1996a, pp. 6-9. Data are variously taken from 1993 and 1994 results.

<sup>31</sup> Bennett, Goldberg, and Hunte, 1995, p. 8.

These cases demonstrate the difficulties in developing a linking approach where the facilitating NGO itself is not totally cognizant of or committed to the imperatives of a financial systems approach.

It should also be noted that the literature reviewed does not provide further insight into the methodologies used by linking programs to form groups and negotiate relationships with banks on their behalf. Such detailed information might improve understanding regarding what best practice might be with respect to this approach, as well as the sequencing of organizational and financing steps that are followed.

In contrast, the literature is much more robust with respect to parallel models.<sup>32</sup> Logically, the direct approach makes more sense where options for linkage are not available because of geographic or institutional distance, or where the implementing institution sees a greater advantage in building an autonomous financial system with the aim of being more responsive to the poor. These systems are also a challenge to build well, because they involve the need to develop a whole range of institutional skills and to amass large sums of capital to fuel their growing portfolios. It is interesting to note that many of the more successful programs known to the microenterprise community are of this second type. Faced with unresponsive financial systems in most quarters of the world, microenterprise practitioners have taken on the challenge of demonstrating alternatives that are effective on both financial and social terms.

In summary, understanding the effectiveness of an institution's social intermediation activities depends on understanding what its goals are — what it is seeking to achieve on behalf of its clients, and how it has structured its role within a system of social and financial services. For those that take on the demands of setting up an independent program, the imperative of financial sustainability, along with outreach, are critical indicators of success. For those that choose a brokering, or linking, role, the challenge is to ensure that a sustainable system will be the result of the efforts, and that a clear exit strategy exists.

## **FEATURES OF EFFECTIVE SOCIAL INTERMEDIATION**

Whether the model is parallel or linked, whether the group form encouraged is small like solidarity groups or large like village banks or credit unions, observers have associated a set of programmatic characteristics with effectiveness. These characteristics relate to the institution's approach to and relationship with its clients, its attitude toward financial sustainability, the nature of the group formation and capacity building that it engages in, and, finally, its approach to savings. Most of these characteristics are not new to those in the enterprise development field — they are attributes long associated with best practice. It is worthwhile recapitulating them here, however, in light of some recent observations that question how they work in different settings.

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<sup>32</sup> Materials exist that outline the methodological aspects of solidarity group and village banking programs, and that discuss the methodologies of savings-led strategies, such as self-help groups, savings and credit cooperatives, and credit unions. Cases of all models are also available. The bibliography provides a full listing of this material.

## Relationship to Clients

*Outreach:* Effective social intermediation programs focus on outreach to the poorer members of the community. This focus is expressed sometimes by targeting screens (such as maximum land holdings and employment status, or geographic focus), but, more often by the nature of products and services offered (very small, rapid turnover loans), and the participation requirements that clients are expected to meet (regular meetings, peer guarantees).<sup>33</sup> The intention is not only to serve the poor, but also to serve them in significantly large numbers to make a real impact both on their lives and on the financial system itself. The commitment to outreach is conveyed by methodologies that emphasize field-based promotion and decentralized operations — taking banking services to the poor.

*Market Orientation:* This, rather than social service, characterizes how they treat clients. As noted by Berenbach and Guzman in reference to solidarity group programs, client capacities as microentrepreneurs and as participants in the credit screening process are now respected while the organizations recognize their responsibility to provide a reliable service at a reasonable price, which creates real value for their customers.<sup>34</sup> This mutual accountability and trust has been essential to enable these programs to attract and maintain a large client base. Tremendous loyalty has emerged among the borrowers and their lending institutions. This same orientation has been found operating in other methodologies as well.

*Client Responsibility:* This responsiveness to clients is matched by an equal emphasis on client responsibility to the programs. Principal in this is the establishment of clear contractual relationships that involve rewards and consequences for specific client behaviors. Central to this responsibility are the peer guarantee, the group responsibility to collect loan payments, and the linkage of future, larger loans to prompt repayment of earlier ones.

*Self-Selection:* Although the programs orient the group formation process, groups are expected to select their own members. This self-screening feature is considered vital, because group members will be asked to share a collective responsibility. And although the program will assist with organizational orientation and other training, participation decisions rest in the clients' hands: the group's own dynamic, beginning with self-selection, is the impetus for successful group lending.<sup>35</sup>

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<sup>33</sup> Timothy Besley and Ravi Kanbur, 1991, "The Principles of Targeting," in V. Balasubramaniam and S. Lall, eds., *Current Issues in Development Economics*, London: MacMillan, suggest that administrative costs as a proportion of revenues may rise exponentially as targeting is made more precise (for example, by the application of income and asset ceilings). In reporting this proposition, David Hulme and Paul Mosley (1996) respond, however, that to the extent that program eligibility is self-targeted, that is to say, directed to the poor automatically by the giving out of small loans only, the problem falls away (Vol. 1, p. 36).

<sup>34</sup> Berenbach and Guzman, 1992, p. 15.

<sup>35</sup> *Ibid.*, p. 17. It should be noted that while this feature correlates with one program aim, building a sustainable financial service, it may correlate less well with another program aim, to reach the poorest. See the section on Critical Issues for further discussion of this point.



## Approach to Financial Sustainability

Like all microfinance programs, those that incorporate social intermediation must be committed to sustainability of their financial services. This implies a businesslike approach on the part of the service provider, and is reflected in an undeviating emphasis on cost efficiency in administrative operations, full-cost pricing of products and services, and scale-up to reach large numbers of clients. For those programs building parallel financial intermediation systems, this focus on sustainability carries with it the expectation that the costs of all core social and financial intermediation services will ultimately be covered by program-generated revenue. For linkage models, the situation is more difficult because the two services, by definition, are delivered by separate institutions. Additional social intermediation that seeks to deliver or create access to other services such as literacy, family planning, and immunization also warrants subsidies. “The challenge is to maintain clarity about these distinct dimensions of delivering integrated financial and other services to the poor.”<sup>36</sup>

## Group Formation and Capacity Building

*Group Characteristics:* The quality of the group influences strongly how successfully it will serve as a vehicle for financial intermediation. Researchers have identified a set of attributes that appear associated with better performance. Goldberg and Hunte, looking at five Asian programs, signal the importance of powerful, local leaders respected by the group; at least a few literate members; single gender groups; self-selection of members; and group enforcement of both incentives and sanctions, “with recourse to an outside source of authority for resolution of serious conflicts.”<sup>37</sup> Two other authors note the importance of homogenous groups, where members are relatively similar in economic and social status, where they come from a small restricted area, and know each other personally.<sup>38</sup>

*Group Size:* Effective programs develop a group size that supports the twin aims of both assuring mutual accountability and of cost efficiency. Finding that size is not always an easy matter. As Hulme and Mosley comment: “Two problems with the group concept will immediately be apparent. The first is that consideration of minimizing administrative cost — or at any rate, the lender’s administrative cost — favour large groups, whereas considerations of minimizing default favour small groups which will stand a better chance of effectively monitoring one another’s behaviours — and of being genuinely like-minded individuals in similar material circumstances, who will have *pro tanto* less temptation to exploit one another.”<sup>39</sup> The smaller the group, the tighter the intergroup linkages and the more effective social penalties against repayment.

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<sup>36</sup> Bennett and others, 1994, p.4

<sup>37</sup> Bennett, Goldberg, and Hunte, 1995, p. 6.

<sup>38</sup> Hatch and others, 1997; Syed M. Hashemi and Sidney Schuler, 1997, “Sustainable Banking with the Poor: A Case Study of the Grameen Bank,” JSI Working Paper, No. 10, June 2.

<sup>39</sup> Hulme and Mosley, 1996, Volume 1, pp. 27, 32.

FINCA/Honduras had a mandated minimum group size of 25, which led to forced borrower selection and thereby greater heterogeneity, with negative repercussions. The NGO eliminated that requirement, and, with an incentive system for promoters that rewards both outreach (number of clients) and repayment, the average group size dropped to 21.<sup>40</sup> Hashemi and Schuler note that the Grameen Bank's two-tiered system of solidarity groups and centers (comprising six to eight solidarity groups) successfully bridges the two aims. The primary group of five is small enough to make close personal relationships and frequent contact among members possible; the larger group is more efficient for conducting credit transactions, and giving the members a sense of belonging to an important community organization.<sup>41</sup> Some village banking programs have incorporated the solidarity group within the village bank for similar reasons.

*Discipline and Routine:* Capacity building focused on making sure the rules of the game are understood is the first requirement of effective intermediation. Rules are strictly applied, starting with meeting attendance and meeting procedures, which are routinized in terms of agendas, roles, and responsibilities. "Mandatory attendance at weekly meetings is another feature that screens out individuals who may lack the sincerity and discipline to repay their loans on schedule, and for instilling discipline."<sup>42</sup> Also, "rituals such as chanting, saluting, and physical drills... promote identification with the organization... and build discipline among members," thus contributing to collective socialization. Not only must the actions of group members be routinized, but also those of the promoters in their conduct of training. For FINCA/ Honduras, this has meant moving from a fairly informal and improvised approach to training to one in which all promoters apply consistent training content and methods.<sup>43</sup>

*Simplicity and Transparency:* Administrative procedures and bookkeeping systems developed for group management must have simplicity and transparency. The procedures must be within the reach of minimally educated group members, and have sufficient controls to ensure that group leaders are accountable to the membership, and that all members are aware of the status of loan payments, group funds, and individual savings, for example. One aspect of this is conducting all transactions in public settings to minimize corruption and suspicion.<sup>44</sup> Building these management and accountability systems is one of the greatest challenges for those social intermediation programs that aim to develop autonomous groups that control their own savings and loan pools. Village banking programs, for example, in which the internal account (a fund composed of member savings, fees, fines, and interest revenues) is seen as the critical vehicle through which groups build assets and autonomy, have found the establishment of appropriate policies, tools, and training procedures a significant challenge.

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<sup>40</sup> Hatch and others, 1997.

<sup>41</sup> Hashemi and Schuler, 1997.

<sup>42</sup> Ibid., p.38.

<sup>43</sup> Hatch and others, 1997.

<sup>44</sup> S.M. Hashemi and S.R. Schuler, 1994, "Credit Programs, Women's Empowerment, and Contraceptive Use in Rural Bangladesh." *Studies in Family Planning*, Vol. 25, No. 2.

*Risk Phasing:* As part of the development of these critical management skills, effective programs develop methods of risk phasing that allow programs to build clients' capacities as well as test their integrity in a way that reduces the hazard for each side. One model of risk phasing proposed by Goldberg and Hunte (1995) suggests five phases:

Phase 1	Phase 2	Phase 3	Phase 4	Phase 5
Group Formation	Savings	Seasonal Credit (working capital)	Term Credit	Group Transformation

In this schema, groups are formed, demonstrate their commitment and discipline through savings first, then manage smaller and ultimately larger amounts of credit, and finally transform into independent actors, "able to make strategic and operational changes as conditions warrant." This conception of risk phasing is linked with another concept called the participation continuum, in which group members can play four major roles, as:

Beneficiaries	Clients	Investors/Shareholders	Managers
Recipients of Free Services	Participants in Contract relationships establishing mutual responsibilities	Owners of assets in a financial institution	Strategic and operational decision-makers

Bennett notes that "most successful systems have moved along the continuum to the point where they view participants as clients: these systems invest in setting up timely feedback mechanisms to make sure they stay in touch with what their clients want. They also make sure that there is a clear contract that lets the client know what she or he must do in return to keep the services coming. Other projects have moved further along this continuum and devolve decision-making power to participants as shareholders or even as managers. In geographic settings where long distances cause isolation, such as rural areas of Nepal and Bolivia, these more intensive forms of participation may be the only way that the cost and risks of serving difficult-to-reach groups can be reduced sufficiently to enable the service to continue." Projects can be designed to prepare clients to move along this continuum of increased responsibility by using risk-phasing measures accompanied by significant investment in skills building. But, Bennett notes, not all clients are equally willing to take on these higher degrees of participation: "The poorer the client and the lower her level of human capital endowment, the less able she may be to accept the risk and devote the time required. . . . While there is no necessary 'evolution' toward the full group ownership and management end of the continuum, it does appear that projects where group members remain in the passive 'beneficiary' role are almost guaranteed *not* to achieve financial self-sustainability."<sup>45</sup>

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<sup>45</sup> Quotations in this paragraph from Bennett in forthcoming book edited by Von Pischke, pp. 2-3.

Gradually increasing loan size based on repayment performance, setting loan size in relation to savings amounts, and offering access to additional loan types based on past performance are all aspects of risk phasing used in successful programs. Within the ACCION affiliate system, this risk phasing is demonstrated by a move from a “highly inflexible” set of loan amounts and terms offered to solidarity group clients at the earliest stages of their program participation to more flexible amounts some 18 to 24 months further on. The larger, longer-term amounts are felt to be more conducive to business development and mark a recognition that the client is ready for a more sophisticated relationship with the program.<sup>46</sup>

## Savings

One of the more important, and challenging, components of effective social and financial intermediation systems is savings. Savings serve many purposes: first as a demonstration of discipline and commitment to the program (credit unions, especially, demand that clients save first before gaining access to loan capital; others do likewise); second, as a guarantee against outstanding loans (in many instances, these savings are mandated payments to group emergency funds); third, as a financial asset that the poor can accumulate against emergencies and long-term needs; and, fourth, as a source of loan capital for the programs themselves, either directly or indirectly. Berenbach and Guzman report that for ACCION affiliates, “the savings requirements have become increasingly important to the programs. As the volume of savings has grown, programs have used these funds as a negotiating tool for leverage with local financial institutions.” In 1992, such savings amounted to between 12 and 24 percent of the value of the programs’ active portfolios.<sup>47</sup>

Bennett, Goldberg, and Hunte, 1995, highlight savings as one of the most critical features in the success of group-based models; their analysis of five Asian organizations has led them to believe that the source of loan funds can directly affect a member’s repayment performance. “The use of internal funds from member savings, internally managed fees and interest earned on loans (also known as ‘hot money’) are believed to instill greater respect for loan contracts by borrowers and an increased sense of ‘ownership’ and interest in contract enforcement by all group members. Sources of external funds such as government programs or NGO initiatives (‘cold money’) may be called loans but are often perceived by members as poorly disguised grants.” (pp.8-9.)

Among the organizations studied, two organizations, the Federation of Thrift and Credit Cooperatives (known by its Sri Lankan acronym, SANASA) in Sri Lanka and the Cooperative Development Foundation in Andhra Pradesh, India, rely almost exclusively on internally generated savings as a source

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<sup>46</sup> Berenbach and Guzman, 1992, p. 50.

<sup>47</sup> Ibid., pp. 52-53.

of loan capital, and both were cited with repayment rates of 94 percent and 98 percent, respectively.<sup>48</sup> The three other organizations, MYRADA in Karnataka, India, the Sarhad Rural Support Corporation in Pakistan, and the Rural Self-Reliance Development Center in Nepal (RSDC) all provide loan capital from external sources, and their estimated repayment rates ranged from 48 to 55 percent.<sup>49</sup> What these researchers believe to be important is the level of external funding available. Bennett (1996a) comments that “the problem comes when donor funds dominate and reduce the system’s accountability to the market — and to the group members.”

This perspective — that ownership of funds is integral to the proper functioning of a group-based financial system — would be endorsed by credit union observers, who have seen some systems destroyed by an influx of donor money. It is also interesting to note that village banking systems have also calibrated external funding to the capitalization levels that community banks have been able to mobilize. Yet, other models, particularly solidarity group lending programs, have demonstrated a capacity to maintain high levels of repayment performance while using grant and external loan capital. In these instances, however, program clients are precisely that — clients, rather than owners and managers. Management, and therefore ultimately the rules of the game, remain in the hands of an external body that demands accountability for continued access. It is more likely that the source of funding becomes significant in those social intermediation programs that seek to develop autonomous, popularly controlled systems of financial intermediation, formal or informal. In these instances, sense of ownership and awareness of risk are dampened by external capital infusions with the result that enforcing repayment discipline becomes more difficult.

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<sup>48</sup> SANASA in Sri Lanka is an example of a thrift and credit society that operates a range of financial services in line with the needs of its members (including very poor households). It is composed of a three-tier structure of “primary” societies, district unions, and a national federation, which accommodates 8,000 village-level thrift and credit cooperatives with 80,000 members. Village groups are highly heterogeneous and vary in size from 20 to 700 members, with the larger ones having turned themselves into small-scale banks. The second and third tiers of this structure provide financial and technical support to the village cooperatives. The financial services offered by the cooperatives are varied and flexible. A village group is autonomous and decides its own range of loan types and savings facilities, which evolve in relation to member needs and local economic circumstances. A society of 60 members may have as many as 10 different types of credit facility. One of the advocacy roles SANASA plays is to convince “primary” societies of the viability of bringing poorer members into the cooperatives, and providing services which will meet their needs. These services have included making the purchase of the share easier through time installments, and through offering a variety of loan products more amenable to the needs of the poor (R. Montgomery, 1996, “Disciplining or Protecting the Poor? Avoiding the Social Costs of Peer Pressure in Micro-Credit Schemes,” *Journal of International Development*, Vol. 8, No. 2, pp. 294-296; and in Johnson and Rogaly, 1997, pp. 41-42, who cite Hulme, D. and Montgomery, R., 1994, “Cooperatives, Credit, and the Poor: Private Interest, Public Choice, and Collective Action in Sri Lanka, Savings and Development, 18 [3]).

<sup>49</sup> Bennett, Goldberg, and Hunte, 1995, pp. 8-9.

## COST-EFFECTIVENESS, EFFICIENCY, AND SUSTAINABILITY IN SOCIAL INTERMEDIATION

Earlier sections of this paper outlined the purposes for social intermediation and the key characteristics associated with programs that have been considered effective in achieving these purposes. But are the costs associated with implementing these programs reasonable when compared with the benefits they provide? The research seems to indicate that the answer is yes. This section will provide a summary of the principal observations found in the literature.

Analysis of program costs for leading group-based microfinance programs demonstrates that these programs can reach large numbers and perform effectively in loan recovery while, at the same time, displaying efficiency in their operations and an ability to approach sustainability. Significant differences in performance and costs between better-performing group-based and individual lending schemes are not discerned.

Also, the literature indicates that transaction costs for formal financial institutions and borrowers are lower for social intermediation undertaken through a *linking* model, where an NGO plays an intermediating (promoter) role between the borrowers and banks, than through the *parallel* or group-based models. NGOs, of course, will have some significant costs when they choose to engage in social intermediation for their clients.

### Group-Based Lending Programs

*Research indicates that group-based lending programs serve large numbers of the poor and achieve high rates of recovery.* In a study of 11 microfinance institutions, Robert Christen and others provided indicators of outreach and financial viability for both group-based and individual lending models.<sup>50</sup> For the group programs, the number of borrowers reached ranged from 5,000 to 1.6 million, and assets ranged from \$1.7 million to \$238.7 million. The rate of growth in borrowers over the three-year period from 1990 to 1993 ranged from 23 to 107 percent, demonstrating both a real vitality on the part of the institutions and a strong response from their client markets. The individual programs (all based in Indonesia) generated higher volumes of clients and assets (from 145,000 to 1.89 million clients, and assets from \$25.6 million to \$2,288 million). BRI's program represented the high end of the scale. With the exception of BRI, the maximum number of clients and assets were 907,000 and \$62.6 million, falling within the same range as the group-based programs.

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<sup>50</sup> Robert Christen, Elisabeth Rhyne, R. C. Vogel, and C. McKean, 1995, *Maximizing the Outreach of Microenterprise Finance: An Analysis of Successful Microfinance Programs*, U.S. Agency for International Development: Program and Operations Assessment Report No. 10, June. The institutions for which outreach data provided included: BancoSol, Bolivia; BKD (Badan Kredit Desa) and BRI (Bank Rakyat Indonesia), Indonesia; CorpoSol, Colombia; FINCA, Costa Rica; Grameen Bank, Bangladesh; KREP, Kenya; and LPD (Lembagan Perkreditasi Desas), also Indonesia. Financial viability data was available for all of these as well as ADOPEM (la Asociacion Dominicana para el Desarrollo de la Mujer), the Dominican Republic, and BRK, Niger. Within this group of institutions, all applied group-based methodologies with the exception of the three Indonesian institutions.

These outcomes were achieved while, at the same time, the institutions covered a large portion of their costs. Four of the sample were reported to have achieved or moved very close to operational efficiency — defined as covering all their nonfinancial expenses (including salaries and administrative costs, depreciation of fixed assets, and the cost of loan principal lost to default). The range was from 94 to 106 percent. In addition, two of the group programs were defined as having achieved full self-sufficiency (that is covering operational expenses and financial costs, calculated on a commercial basis). The rates reported were 107 and 124 percent.<sup>51</sup>

Other researchers have also reported that group-based programs can cover their costs. Genesis Empresarial in Guatemala had revenues of 35 percent of average outstanding portfolio, and total expenses (including financial costs) of 34 percent (1990 figures).<sup>52</sup> Four village banking programs (World Relief/Honduras, CRECER/Bolivia, FIAM/Thailand, and FINCA/Honduras) reported having achieved between 97 and 131 percent of operational self-sufficiency at the end of their 1994 fiscal years. Ten of 68 village banking programs (14.7 percent of the sample) reviewed in a study of this methodology had achieved more than 90 percent self-sufficiency at the same time. Although most of the sample were clustered at the lower end (27 programs had achieved less than 25 percent self-sufficiency), this was largely attributed to program age. The oldest program in the sample, FINCA Honduras, was 10 years old. Eighteen mature programs were between four to seven years old, and the balance were operational for three years or fewer.<sup>53</sup>

The extent to which these programs can achieve full financial viability is less clear than is the case for operational self sufficiency. Although the study by Christen and others (1996, p. 27) identified a few cases of financial self-sufficiency, the authors concluded that “the results regarding full self-sufficiency are less conclusive [than those for operational self-sufficiency]. . . . Because three of the five fully self-sufficient institutions are in Indonesia, this assessment cannot state conclusively that full profitability is routinely possible. The rapid development of BancoSol and...trends at other institutions, however, suggest that in several years this level may be consistently achieved in a range of settings.”

Hulme and Mosley (1996), by contrast, are less sanguine. Their study of 13 programs (eight using a group lending methodology) found that in applying Yaron’s Subsidy Dependence Index to their financial data, the result was positive for all except the long-established BRI from Indonesia. The SDI measures the extent to which the lending interest rate would have to be raised to cover all operating costs if any subsidies the institution receives were stripped away. It was more than 100 percent for all the non-Indonesian institutions in the study, implying that lending interest rates would have to be more than doubled for these institutions to meet all the real resource costs they impose on the economy out of current income. The authors further state that “we know of no micro-enterprise finance institution anywhere outside Indonesia with an SDI of less than 100 percent, with the exception of the Bank of Agriculture and Agricultural Co-

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<sup>51</sup> The institution reporting the highest level was CorpoSol — regrettably a level that was not able to be maintained. Subsequent to this study, CorpoSol suffered almost fatal financial difficulties because of management issues.

<sup>52</sup> Berenbach and Guzman, 1992, p. 36.

<sup>53</sup> Nelson and others, 1996, pp. 50-52.

operative (BAAC) in Thailand, which is estimated by Yaron (1990) to have had an SDI of 23 per cent in 1988."<sup>54</sup>

Whether their inference is true — that financial self-sufficiency for microfinance programs will be rarely achieved — is subject to debate. The data they used in their study is based on average performance from 1988 through 1992, when many programs were still in a state of expansion, whereas the data for the analysis by Christen and others (1995) was from 1993. Nevertheless, the conclusion one draws from these comments is that the group-based models are at apparently no greater disadvantage than individual microfinance models in moving toward full viability. And, in operational self-sufficiency, they have held their own.

*Group-based programs can also be efficient.* Contributing to the level of self-sufficiency attained is the degree of efficiency at which programs operate. Christen, Rhyne, and others report that successful programs of this type demonstrate administrative costs in the range of 10 to 21 percent of the loan portfolio, with one exception (ADOPEM at 36 percent).<sup>55</sup> Hulme and Mosley also report administrative expenses ranging between 11 and 33 percent for the successful group programs in their study. Similarly, individual-based lending programs were found to have administrative expenses ranging between 8.1 and 27 percent of loan portfolio. The authors include in their estimates of administrative costs the following items: loan supervision, insurance costs, research and training (and support of other institutions), and other costs. Within this package, loan supervision costs comprised the most significant portion of the expense. Except for Grameen Bank and the Malawi SACA Farmers' Club (whose costs were 4.3 and 8 percent, respectively), the loan supervision costs for the group programs fell between 16 and 19 percent. The individual-based microfinance programs, on the other hand, had loan supervision costs between 6 and 9 percent.<sup>56</sup> This more time-intensive focus on loan supervision by group-based programs may be attributed to the dynamics of the weekly and biweekly meeting schedules that most programs maintain, which are an integral part of repayment discipline.

A second measure of efficiency is found in borrower-to-staff ratios, which are high: for BRAC and Grameen, they have been documented at 209 and 131 to one, respectively.<sup>57</sup> A sample of 10 solidarity group programs submitting data to the Economics Institute at the University of Colorado reported an average of 102 loan clients per staff member. A sample of five village banking programs reported an average of 203 borrowers per staff member, reflecting the larger groups with which loan officers work

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<sup>54</sup> Hulme and Mosley, Volume 1, 1996, pp. 43-47, 83.

<sup>55</sup> Christen, Rhyne, Vogel, and McKean, 1995, p.38.

<sup>56</sup> Hulme and Mosley, Volume 1, 1996, p. 48. The group-based programs include BancoSol, Bolivia, Grameen Bank, and BRAC Bangladesh; SANASA, Sri Lanka; K-REP, Kenya; and SACA Farmers' Clubs, Malawi. Individual programs included BRI and BKK, and KURK (the Kredit Usaha Rakyat Kecil), Indonesia; the RRBs of India; and the Kenya Industrial Estates informal sector program in Kenya.

<sup>57</sup> Ibid., p. 164; 1991 data.



under this methodology.<sup>58</sup> These ratios are in the same range as individual lending programs. Thirteen programs reporting to the Economics Institute averaged 112 per staff member.<sup>59</sup>

Note that borrower-to-loan-officer ratios (as opposed to all staff) ascend even higher. The Private Sector Initiatives Corporation (PSI), for example, reports that BancoSol's ratio is 416 to one. This is in the same range as a sample of individual lending programs that PSI also reports on: from 407 to one for Women's World Banking Cali, to 518 to one for Caja de Ahorro y Prestamo Los Andes.<sup>60</sup>

*Compared with individual lending programs, group-based lending offers lower interest rates to borrowers, but transaction costs are higher.* When microfinance models are compared with linking models or with traditional formal financial systems, there is a difference in the package of costs that borrowers are expected to pay for their services. Hulme and Mosley note that although all successful programs develop a combination of interest rates and transaction costs that borrowers find attractive, how they distribute these costs differs: "At one extreme are BKK and KURK with high interest rates and low transaction costs [approximately 80-90 percent, but less than 20 hours annually to acquire and service a loan]; at the other are the Grameen Bank and BRAC with relatively low interest rates and heavy transaction costs [around 20 percent, but requiring between 80 to 90 hours annually]. The financial market for low-income groups still awaits the breakthrough that would combine low interest rates with low transaction costs!"<sup>61</sup> As mentioned earlier, the higher time demands are a function of the work involved in building social capital, as well as of the need to off-load some of the administrative burdens from the programs to the clients. Although this trade-off appears tolerable to many poor people, there are settings in which clients have found this difficult to bear. More will be said about this in the next section.

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<sup>58</sup> Robert Peck Christen and Jennifer McDonald, 1997, *The Microbanking Bulletin*, Boulder: The Economic Institute, Vol.1, No.1, p.31. The solidarity group programs include Accion Comunitaria del Peru, ADOPEM (Dominican Republic), BancoSol (Bolivia), CorpoSol (Colombia), Emprender (Argentina), FAMA (Nicaragua), FUPACODES (Paraguay), Genesis (Guatemala), PRODEM (Bolivia), and TSPI (Philippines). The village banking programs include ASA (Bangladesh), Compartamos (Mexico), FINCA (Costa Rica), Grameen (Bangladesh), and Sartawi (Bolivia). Agencies reported data no earlier than 1993; the majority of the reports are for 1996.

<sup>59</sup> Ibid. Programs reporting included Alexandria Business Association (Egypt), ACEP (Senegal), BKDs, BRI (Indonesia), Calpia (El Salvador), Corporacion Mundial de la Mujer/Medellin (Colombia), FIE (Bolivia), FMM/Pop (Colombia), FWW/Cali (Colombia), Liberacion (Chile), LPDS (Indonesia), Los Andes (Colombia), and Propesa (Chile).

<sup>60</sup> Private Sector Initiatives Corporation, 1997, Rating Agency for Microlenders Fact Sheet, December, for BancoSol, Caja de Ahorro y Prestamo Los Andes, and Fomento a Iniciativas Economicas (all in Bolivia), and Women's World Banking and Cali in Colombia.

<sup>61</sup> Hulme and Mosley, Volume 1, 1996, p. 169.

## Linking Model

*Transaction costs for both banks and borrowers are reduced when their lending relationship is indirect — when a linking model is used.* Linkage models were associated with lowered costs for banks and for borrowers. As one author noted, lending organizations achieved savings in recruitment and screening costs, because the most needy and the most potentially productive members of rural communities — the women — are almost invariably the most reliable and the most profitable. Women self-select as group members, and there is no need to steer assistance to them through positive discrimination.<sup>62</sup> Two other studies, undertaken by the Australian Foundation for Development Cooperation's Banking With the Poor Project, set out to quantify the transaction costs of commercial banks and NGOs in lending to the poor and the transaction costs facing poor borrowers in India and the Philippines. The India Study compared four different channels of credit:<sup>63</sup>

- **Model 1:** The bank lends directly to poor borrowers.
- **Model 2:** The bank lends directly to poor borrowers, with NGOs involved as nonfinancial intermediaries (introducing borrowers to the banks, undertaking training, and so forth).
- **Model 3:** The bank uses self-help groups as financial intermediaries to lend to borrowers, and the NGO provides nonfinancial services.
- **Model 4:** The bank provides credit to the NGO which in turn on-lends to self-help groups that further on-lend to the borrowers.

In these instances, both the banks and borrowers benefited from the last two models. The banks had lower costs (for borrower identification, loan application and document verification, and loan appraisal, approval, disbursement, monitoring and recovery) using model 3. Recovery results were also significant: the study reported that the average repayment rate for borrowers receiving credit through the direct lending model was only 35 percent, while the involvement of NGOs and self-help groups led to dramatic improvements in repayment performance, ranging from 81 percent under model 2 to 97 percent under models 3 and 4.

Borrowers had the lowest transaction costs vis-à-vis the formal financial institutions in model 4. The authors identified a reduction of up to 85 percent when the loan was delivered under this model (model 3 provided almost as good results). Borrowers had no expenditure on documentation procedures, and made fewer visits to the bank to deposit funds. In the Philippines study, in which two projects administered

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<sup>62</sup> Malcolm Harper, 1996, "Self-Help Groups: Some Issues from India," *Small Enterprise Development*, London: Intermediate Technology Publications, Vol. 7, No. 2, pp. 37-38.

<sup>63</sup> V. Puhazhendi, 1995, "Transaction Costs of Lending to the Rural Poor: Non-governmental Organizations and Self-help Groups of the Poor as Intermediaries for Banks in India," Brisbane, Australia: Foundation for Development Cooperation. The analysis of transaction costs was based on a sample of 108 accounts from branches of three banks: a regional rural bank, a public commercial bank, and a private commercial bank. Part of the sample for Model 3 was drawn from loans by the private commercial bank to self-help groups organized by MYRADA.

by NGOs (unidentified in the report) were considered, borrower costs ranged from 1.8 to 6.3 percent of average loan value.<sup>64</sup> Costs were defined as loan application fees, loan insurance, transport costs to attend meetings, and a share of the cost of turning over weekly collections to the NGO office. Not included was an estimate of the opportunity cost of attending meetings, but the authors noted that members considered that meetings provided positive benefits in terms of camaraderie, mutual encouragement, and spiritual formation.

Of course, these analyses do not explicitly consider the costs of the NGOs in these instances. Model 4 programs can be designed for self-sufficiency with the NGOs covering costs off the spread between their borrowing costs and the interest/fee charges they apply to borrowers. Models 2 and 3 present different issues. As discussed earlier, subsidies under Model 2 programs can be justified if designed as time-limited interventions focused on capacity building of banks and borrowers. Sustainability of nonfinancial services, offered under Model 3, may need to be addressed outside the financial services framework. McGuire and Conroy, in reporting on these studies, note with respect to the India case that: "A key conclusion from the study is that intermediation by NGOs and SHGs leads to significant reductions in transaction costs facing banks in lending to the rural poor. Hence identifying strong and effective NGOs and SHGs to act as intermediaries between banks and final borrowers is likely to yield considerable benefits in an appropriately supportive regulatory environment."<sup>65</sup> One implication of these remarks is that NGO intermediation services might well be financed from these savings, benefiting all parties involved.

## Subsidies

*Several authors confirm the undeniable reality that intermediation programs require substantial investments to begin operation.* Bennett comments that significant additional costs are incurred at the start in building the skills and systems that permit the target group to eventually take over most of the management of their own transactions. Thus, if they are to achieve sustainability, financial services projects for the poor require substantial up-front investments in human resources and local institution building. These costs can be expected to be a larger part of the project funding than the actual "credit" disbursed to the group members, especially in the early years of the system's establishment.<sup>66</sup>

Hulme and Mosley (1996) document subsidies for the period between 1988 through 1992 for a variety of their case study institutions, both group and individual-lending models.<sup>67</sup> These are summarized in the table below.

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<sup>64</sup> G. M. Llanto and R. T. Chua, 1996, "Transaction Costs for Lending to the Poor: a Case Study of Two Philippine Non-government Organizations," Brisbane, Australia: Foundation for Development Cooperation.

<sup>65</sup> Paul D. McGuire and John D. Conroy, 1997, "Bank-NGO Linkages and the Transaction Costs of Lending to the Poor through Groups," *Small Enterprise Development*, London: Intermediate Technology Publications, Vol. 8, No. 1, March, p. 9. For their discussion, McGuire and Conroy draw on Puhazhendi, 1995, and Llanto and Chua, 1996.

<sup>66</sup> Bennett, forthcoming, edited by Von Pischke, p. 9.

<sup>67</sup> Subsidy is defined as financial inflow less value of repayments by lender to sponsor organizations.

TABLE 2  
PROGRAM SUBSIDIES

Group-Based Programs		Individual Programs	
<i>Institution</i>	<i>Value of Subsidy</i>	<i>Institution</i>	<i>Value of Subsidy</i>
BancoSol	\$ 4.6 million	BRI	\$ 20.0 million
Grameen	\$ 25.0 million	BKKs/KURKs	\$ 10.0 million
BRAC	\$ 29.1 million	KIE-ISP	\$ 1.9 million
K-REP	\$ 9.4 million		

What the authors further note is that “if we examine the behavior of sponsors in relation to ‘experimental’ lending institutions over the last ten years, we notice an interesting schizophrenia. All of them subsidize their clients; and all of them denounce subsidy, on principle, as wrong. . . [Yet] not one of the ‘successful’ institutions has negotiated the knife-edge without subvention from some external fairy godmother.” Like Bennett, they argue that time-bound subsidy should be recognized as a necessary investment in building strong lending systems, and conclude, “We believe that the tying of subsidies to defined external benefits through a fixed-term performance contract is only a necessary, and not a sufficient, condition to make subsidies effective. The additional condition which must be satisfied is that potential poor borrowers need to be identified and linked with the credit supplier through a process which combines the functions of social organization and financial linkage —social intermediation, as Lynn Bennett calls it.”<sup>68</sup>

### Comparative Costs and Benefits of Different Strategies

*The literature is silent on comparative costs and benefits of different social intermediation strategies.* It seems logical to assume that different types of social intermediation carry different costs and benefits. Straightforward solidarity group programs that offer a very limited package of organizational services aimed at creating the information asset embodied in the group guarantee and an administrative mechanism, would seem likely to be less expensive than programs focused on building village banks that need to manage two loan pools, or savings and credit cooperatives that are expected to develop into autonomous financial intermediaries themselves. In addition, the latter two and other models often have other complementary social interventions aimed at strengthening participant knowledge and skills (such as literacy and numeracy, health, or nutrition). How these costs differ, and the relative outcomes obtained from them, are not easily discerned in the current literature. For program designers seeking to make an informed choice between these programs on, at least partially, economic grounds, there is no clear path. This area of inquiry would be a useful one for future research.

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<sup>68</sup> Hulme and Mosley, Volume 1, 1996, pp. 80-82.

## SOME CRITICAL ISSUES

The case for social intermediation is compelling: it creates a bridge to financial services for poor people distanced by geographical and social remoteness. And, practitioners have forged models that build that bridge in a way that meets the requisites of any good microfinance system: they effectively disburse and collect loans; they can cover at least their operational costs, and in some instances even more; and they facilitate the development of autonomy and skill among their participants in ways that often go beyond the bounds of the simple financial transaction. Nevertheless, these results are not easily obtained. In some instances, practice falls short; in others, gaps remain in our understanding of how best to achieve the desired ends. This section will address some of the more critical issues that face practitioners and researchers in further developing this important component of microfinance.

### **Target Groups: How Deep an Outreach Can These Programs Have?**

At its foundation, social intermediation exists to pave a way for the poorest to gain access to financial services. But do its very methods contradict that goal? Hulme and Mosley present three ways in which the poorest might be excluded:

- First and foremost, the emphasis on credit delivery may not match the poorest clients' needs: "The opportunities for credit-financed self-employment are very limited, and the risks are unreasonably high." Because of this, the poorest in Bangladesh have been found to commonly practice "self-exclusion" from income-generating schemes. As an example, Hashemi and Schuler note that women who doubt they will be able to make timely repayments or fulfill other group requirements are reluctant to join. Largely, these women "either lacked access to a reliable source of income from which to pay weekly installments . . . or they were married to men who were irresponsible and likely to appropriate, or had appropriated, the women's entire loan without providing the money for the weekly installment. Many of the most destitute women . . . fell into one or both of these categories."<sup>69</sup>
- The self-selection principle also leads to other group members "deciding that some prospective members are "too poor" to be given group membership." This exclusion may be either economically or socially based. "Direct cases of exclusion were reported for SANASA, BRAC, TRDEP, and SACA, where members identified some people in the village as being unsuitable for group membership because of the intensity of their poverty."<sup>70</sup>

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<sup>69</sup> Hashemi and Schuler, 1997, p. 14.

<sup>70</sup> Hulme and Mosley, Volume 1, 1996, p. 130.

- The exclusion of these individuals because of deep poverty may make sense not only for the programs, but also for them. More than credit, the poorest may be better served by other approaches to asset and capacity building. Nevertheless, Hulme and Mosley identify a third way that poorer clients may be excluded that relates less to their inherent unsuitability for loans, and more to program established performance objectives. As an example, they point to incentives structures that have been found to lead staff to concentrate on other than the core poor. The authors report that the best evidence of this was found in the case of BRAC, where the average value of new members' assets was "higher than the asset levels of successful third-time borrowers." This change in target group followed a professionalization of management and staff structures, and the establishment of high performance targets for growth and repayment. Hulme and Mosley also note that SANASA is currently wrestling with the same dilemma as it shifts from a largely voluntary staff to one that is more professional.<sup>71</sup>

Richard Montgomery has identified other ways in which staff implementation of program requirements negatively affect the more vulnerable clients. His argument is as follows:

- The starting point for any peer group is self-selection, with the intent of creating relatively homogenous groups in terms of poverty, social status, and other factors. It is assumed that each member will, thereby, constitute a similar degree of default risk, allowing the group to function with some measure of confidence. In fact, while differences in economic well-being among community members may not be readily apparent to outsiders, they are significant and easily observed by the inhabitants themselves. Further, the state of anyone's poverty is not a static matter. "An individual borrower facing a short term (or fundamental) crisis in income or cash flow may suddenly shift from being an ideal "peer" to a "bad risk" if such a crisis coincides with outstanding repayment obligations."
- When a borrower faces one of these crises, the peer pressure exerted can be strenuous. Other group members may be driven less by a concern for mutual support of someone in need than by a need to ensure that they do not have to be responsible for additional financial burdens. Peer pressure can be further heightened when staff threaten to withdraw access to future loans, not only for the small, joint liability group, but for a larger group of borrowers as well (organized at the "center" level in some solidarity models). "The way in which such pressure is brought to bear increases the perception of risk... and increases the exclusionary tendency implicit in many peer group schemes."<sup>72</sup>

As an example of how this can operate, Montgomery cites BRAC in Bangladesh, which he labels a "relatively rigid, top-down, credit-focused scheme which is maintaining high repayment rates, but at the cost of a section of its membership." Field work in three districts of the program (Rajari, Faridpur, and Sherpur) including interviews with 30 village organizations demonstrated that the most vulnerable are often forced to withdraw when crisis hits. Rather than seek support from their peers to make up missed

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<sup>71</sup> Ibid., p. 130.

<sup>72</sup> Montgomery, 1996, p. 290.

payments, the first recourse is kin or close friends. When this strategy is exhausted, individuals may draw upon a range of other coping strategies, again without recurrence to the peer group.<sup>73</sup> BRAC staff, instead of motivating peer group members to exercise their joint liability agreement, instead pressure the larger village organization to resolve the matter, threatening to withhold loans for all the groups in that organization. Montgomery notes that the use of this sanction was freely admitted by program staff in several of the areas studied. He further reports:

Because of staff pressure, and the implications of an individual's late repayments or default for all VO members, collective action against such individuals can be severe. Several VOs provided examples of individuals who had been made to drop out because of their lack of repayment discipline. While it is difficult to confirm in precise terms the economic status of such drop-outs, anecdotal accounts clearly suggested that they tend to be the poorer among a VO's membership.

This exclusionary pressure on the poorer and more vulnerable is rarely discussed in the literature. . . . However, one of BRAC's own research studies recounts a conversation with BRAC women in which 'they told . . . with pride that they had pulled down a member's house because she did not pay back her housing loan.' This dramatic example of violent collective action may not be common — more subtle social sanctions within a community may be all that is necessary. However, examples of 'forced' acquisition of household utensils, small livestock, or other assets of defaulting members were mentioned in several of the VOs. In cases where fellow members had been reluctant to take such collective action, they were either directed by field staff to do so, or the field staff themselves had carried out such action.<sup>74</sup>

Montgomery concludes that while it is difficult to estimate the extent of this exclusionary problem, his impression is that the majority of BRAC dropouts are leaving because of an inability to fulfill the rigid repayment requirements. BRAC's dropout rates were 16 percent for 1992 and 10 percent for 1993.

Finally, Montgomery reports that an additional contributor to the difficult position of poor borrowers in BRAC's case is the lack of ready access to savings or consumption loans. Under the current program design, members may withdraw 25 percent of savings after five years of membership, and larger withdrawals after 10 years. But these funds cannot be accessed in times of emergency. Further, consumption loans go through the "same lengthy administrative procedure as other loans, taking several weeks to be approved. This means they are rarely useful for members unless they can foresee a cash shortage and plan ahead." The situation is further compounded by the lack of a group fund under the

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<sup>73</sup> Such coping strategies follow a hierarchy from the least to the most severe. Lowest stress activities include reductions in current expenditure, changes in diet, calling in other debts, and temporary migration of one or more household members to seek wage employment. Medium stress activities include using up all cash savings, taking on additional debt, and pledging future labor for an advance in wages. At their most severe level, they include mortgaging or selling nonproductive and finally productive assets. *Ibid.*, p.293.

<sup>74</sup> *Ibid.*, p. 297.

control of the participants. The Group Trust Fund that does exist is controlled by field staff, “and they have no mandate to allow everyday use of this money.”<sup>75</sup>

Is the situation Montgomery describes an anomaly? Or can similar exclusionary practices be found in other programs? Julia Paxton and Cecile Fruman report that the *Projet de Promotion du Petit Crédit Rural* in Burkina Faso implements a similar practice of not stressing the joint liability principle when someone is delinquent. Rather, loans are blocked for the group as well as for the “sector,” a village-level collection of about 30 groups.<sup>76</sup> Harper, in looking at programs in Bangladesh and Pakistan, reports that for linkage programs where banks provide loan capital to self-help groups, increases in sums borrowed may exclude poorer members of a group, who may not be able to borrow as much or as frequently as better-off group members, or manage the higher repayment amounts. “In the latter case, they may be expelled, and in the former they may reasonably lose interest, because they are not sharing in the benefits of membership although they are contributing to the savings.”<sup>77</sup>

Not all observers agree with Montgomery’s assessment of peer practice in Bangladesh. Hashemi and Schuler refute his description based on their own observations of BRAC and Grameen Bank. They believe that both Grameen and BRAC are more flexible than Montgomery suggests in accommodating cash flow problems and assisting members when they face economic crises, and that this flexibility mitigates the situation for the poorest. Also, that the level of self-management and relative autonomy of the village cooperatives that exist in SANASA would not be possible in Grameen or BRAC groups given their characteristics and the setting.<sup>78</sup>

Using Grameen as the example, they note that the “rules are rigid, but only to a point.” Center meetings, for example, are not supposed to conclude unless all groups have paid in full. As a result, members will pressure one another to pay, and someone may be sent to find a truant member. “In the event that the other members of a group of five fail to collect an installment from one member, they may advance the money themselves and, in some cases, the center chief may make up the difference. In practice, however, meetings do sometimes close before sums are collected in full. In such situations, the weekly meeting is likely to break up leaving some ambiguity regarding what will happen next. The members are not absolved, or formally given a new repayment schedule. From Grameen’s point of view, it would be unfair and irrational to disband entire centers when some members are unable or unwilling to repay. Eventually, most loans are repaid, as evidenced by the high overall rates.” Further, members in groups with defaulters are usually not denied future loans, only subject to delay until the defaulter is replaced.

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<sup>75</sup> *Ibid.*, p. 297.

<sup>76</sup> Julia Paxton and Cécile Fruman, 1997, “Burkina Faso: Le Projet de Promotion du Petit Crédit Rural—PPPCR,” *Case Studies in Microfinance*. Washington, D.C.: the World Bank’s Sustainable Banking with the Poor project, August.

<sup>77</sup> Harper, 1996, pp. 39-40.

<sup>78</sup> Hashemi and Schuler, 1997, p. 42.



Although it is rare that group members pay on behalf of defaulters unless they believe they will be reimbursed, the group fund is there to cover bad debts. The authors conclude, “In summary, Grameen Bank has simple, rigid rules which are often bent to make the system work, and the ‘bending’ takes place at the field level. . . . Group liability in a strict sense would be perceived as unfair, and would not be accepted by the borrowers; on the other hand, in this social milieu borrowers do accept mutual liability to an extent, and to that extent it is very important in the functioning of Grameen Bank.”<sup>79</sup>

Paul Mosley offers evidence from Banco Sol in Bolivia that better-off members will exercise solidarity with poorer members in solidarity groups that are decidedly heterogeneous. He reports:

In twenty-one of the groups surveyed, or just under half, respondents claimed that there existed people either richer or poorer than themselves and in these groups. . . . there was a much higher likelihood that other group members would ask the respondents for financial help than in those groups where income was seen as being homogenous. . . . [I]n groups where intra-group income differences were significant, richer members were acutely aware of the need to help out if poorer members suffered a short-term fall in ability to pay; indeed, twelve out of the thirteen respondents who stated that there were poorer people in their own groups also noted that other members of the group had asked them for help in occasional months of ill-fortune, and in nearly all cases had been willing to oblige them, sometimes by offering loans with a very short term (the period of a week was mentioned by two respondents). Respondents were explicitly asked about the strategy they would adopt if one member failed to pay his or her quota, but only two mentioned the possibility of taking a defaulter to court; five mentioned moral pressure, but no fewer than ten suggested that any individual member’s arrears problem was a group problem and better dealt with by a group meeting than by individual-to-individual pressure. . . . However, the share [or each member’s contribution to the struggling member] is itself often paid in the form of a *loan* to the group member who cannot otherwise pay, so we are not necessarily talking about altruism so much as a process which may well act to deepen intra-group inequalities as the price for keeping the group going.<sup>80</sup>

Is the difference between BancoSol and BRAC a difference of context, of client populations, or of the institutional ethos each one brings to its work of group promotion and facilitation? Not only does the Bolivian case suggest that poor and poorer can operate within the peer model, but also that homogeneity of groups may not always be a necessary element in effective social intermediation. What is clear is that more research needs to be done regarding specific practices and policies that lend themselves to inclusion and those policies that do not. The case is far from certain in either direction.

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<sup>79</sup> Ibid., p. 39. All quotes are on p.39.

<sup>80</sup> Paul Mosley, “Bolivia: The Case of BancoSol,” in Hulme and Mosley, 1996, Volume 2, p.16.

## **Design Components in Group-Based Strategies: Which Most Support the Participation of the Poorest?**

In contrast to his discussion of BRAC, Montgomery cites SANASA as an example of an institution that has implemented microfinance practices conducive to keeping the poorest in the process. His estimation is that “SANASA cooperatives depend on a broader concept of member responsibility rooted in stronger collective management among the members, and the provision of a range of mechanisms which down-play the perception of risk, actively encourage mutual trust and support, and provide protectional support for members facing economic difficulties.”<sup>81</sup>

The concept of *promotion* of economic activities versus *protection* against loss seems to be key in this regard. Promotional economic strategies are risky, because they are aimed at increasing income through advances in the business; they involve investing in ways that change the way the business is done (such as the purchase of technology or other capital-deepening), and can result in loss. Mosley and Hulme note that borrowers successful with a series of small working capital loans might subsequently move to this higher-level strategy. But for the majority of poor borrowers, the strategic use of the loan is protectional, that is, aimed at only incremental changes in their activities in a way that sustains existing family routines and the maintenance of consumption. The aim is to gradually reduce their vulnerability to crisis. Working capital loans are largely protectional.<sup>82</sup>

Montgomery would argue, however, that the poorest need more protection than the working capital loan itself provides. There is a need for additional mechanisms that can create safety nets for borrowers in times of crisis, over and above the net of the peer group itself. In the SANASA case, these mechanisms are characterized by their “variety and flexibility.” The local societies (or first tier savings and credit cooperatives) offer a variety of loans by size, term, and interest rates determined in relation to the predominant economic activities of the area. Consumption loans are available as “instant loans,” provided literally overnight to people in distress. Due within one month, and with very high interest rates (often the equivalent of 80 percent per year), they nevertheless offer borrowers in trouble a way to survive a crisis without draining their business activity. SANASA also offers a variety of voluntary savings products, providing another coping mechanism.

In addition to these mechanisms, SANASA has also instituted changes in member policy to make it easier for poor people to join. Primarily, this has meant a change in how the initial share is paid. Previously required in a lump sum upon joining, new members are now allowed to buy the share in installments over a year’s time. SANASA also provides flexibility in repayment schedules when people are in difficulty. Variations in the usually monthly repayment can be negotiated with the management committee of each society, composed of local individuals who know the borrower well. In summary, Montgomery recommends the following design lessons for practitioners interested in enhancing the value of their social intermediation services for the poor. They include:

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<sup>81</sup> Montgomery, 1996, p. 291.

<sup>82</sup> Hulme and Mosley, 1996, Volume 1, pp. 94-97, 108-109, 182.

- Matching the emphasis on repayment with an emphasis on also encouraging and supporting additional protectional devices for the poor; he notes that in doing this managers will have to accept that such program development may entail slower organizational growth and longer time horizons for financial viability;
- Offering a broader array of microfinance services than just credit; this includes consumption loans in addition to investment loans, as well as a variety of savings mechanisms;
- Using staff performance indicators other than repayment discipline that encourage attention to social development objectives; and
- Ensuring that local groups have resources which they can manage: “If solidarity groups are to achieve broader objectives and roles, they must have at least some resource which are self-managed, and can be used as local members deem appropriate.”<sup>83</sup>

The way in which social intermediation strategies have addressed some of these elements varies. Village banking’s emphasis on the internal account mechanism, for example, responds to the last recommendation. BancoSol’s efforts to incorporate voluntary savings is an effort to resolve this gap in traditional solidarity group programs. The extent to which programs are willing to heed Montgomery’s call for a slower time frame to viability and an emphasis on social development objectives will depend on institutional mission, as well as the imperatives of self-sufficiency that programs feel placed upon them by donors and others. What this discussion makes amply clear is that the peer mechanism alone is an insufficient condition for ensuring participation of the poorest or of the poorer members of the community.

### **Joint Liability in Peer Lending: How Is It Perceived? What Elements in Its Construction Support or Inhibit Its Functioning?**

Earlier portions of this section have documented some differences between programs in the way the joint liability feature is implemented. The information available suggests that much more needs to be understood regarding clients’ own perceptions of the strengths and weaknesses of this feature, and how other program features — such as structure, supervision, and transparency — affect its functioning.

As an illustration, several authors report on the peer mechanisms within the K-REP Juhudi Credit Programme. Following the Grameen Bank model, borrowers are first organized into solidarity groups of between four and seven members, called *watanos*, and six of these are organized into a *kiwa*, or business association, where all financial transactions are conducted. The liability structure that KREP has established for the payment of loans is as follows: first, the cash flow from the business; second, the

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<sup>83</sup> Montgomery, 1996, pp. 299-304.

member's own savings; third, the *watano* savings; and, finally, the savings of the *kiwa* itself. In fact, *kiwa* members are most reluctant to use their savings to compensate for a delinquent borrower, and they have pressured KREP to pursue delinquents more actively through legal means rather than the group guarantee.

Part of the reason for this sentiment may be that a significant portion of Juhudi members have been affected by defaults. A survey team found, in 1994, that 51 percent of the women and 68 percent of the men belonged to groups that had had defaults by one or more members.<sup>84</sup> Another survey found that 32 percent of respondents had "experienced forfeiture of *watano* savings to cover a defaulter, and over a third of these had responded to this by curtailing or stopping their contributions to voluntary group savings and some had even tried (but were obviously prevented from) stopping their compulsory savings contributions." To stanch this flow, many groups have now reverted to developing verbal or written agreements to pledge some property as security (a fixed asset such as a sewing machine, tools or radio) against default.<sup>85</sup> Given that the point of a group guarantee is to compensate for the lack of material security, it is interesting to see that these groups are reverting to this traditional form of collateral!

Buckley also notes, however, that most groups preferred to use moral suasion rather than repossession to handle these issues, and if the reason for delinquency was due to illness, death, or some other personal catastrophe, "it was common for other members to help out. Occasionally, those in arrears had their repayments paid for them by other members of the *watano* or *kiwa* in exchange for work. An in-house survey of *kiwas* found that slightly more than a third had resorted to the use of police and legal mechanisms in dealing with default, and slightly less than a third had set aside a common fund among themselves to cover defaults."<sup>86</sup>

Group members also appear to undertake an interesting set of calculations with respect to how advantageous it may be to repay. Paxton and Fruman found that in Burkina Faso the rigid enforcement of sector (the label given to the second-tier group) liability appeared to trigger an even higher number of defaults. Given a very rigid interpretation of the liability rules (unlike the practical flexibility that Grameen appears to implement), the authors found a "domino effect in which it is in the best interest of any group to default as soon as another group defaults." This domino effect also operated at the group level as well:

Group solidarity, defined as the willingness of the credit group to pay for one of its members on occasion, functioned well within most of the small groups studied in Burkina Faso where the bond of trust, loyalty, friendship and respect was well developed and truly functional. However, once a member was unable to repay four or five of her weekly repayments, the entire group went into default. Interestingly, the group was the main source of funds that the women relied on in the face of adversity. They rarely borrowed from their husbands, families or friends in bad times. A comparable degree of solidarity was not present in the sector level. Part of this phenomenon can be explained by the fact that individuals do not interact and monitor other groups to the extent that they can within their own group. In

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<sup>84</sup> Catherine Neill, Mario Davalos, Washington Kiiru, M. Manundu, and Jennefer Sebstad, 1994, "The Kenya Rural Enterprise Programme." GEMINI Technical Report No. 77. Bethesda, MD: Development Alternatives, Inc.

<sup>85</sup> Graeme Buckley, "Financing the Jua Kali Sector in Kenya: The KREP Juhudi Scheme and Kenya Industrial Estates Informal Sector Programme," in Hulme and Mosley, 1996, Vol. 2, p. 310.

<sup>86</sup> Ibid., pp. 310-311.

addition, the dilemma of collective action is present as individuals can engage in “free-riding” by relying on the rest of the sector to enforce the repayment of other groups. Hence, it is not surprising to see the domino effect in some groups of the PPPCR.<sup>87</sup>

Paxton and Fruman also found that PPPCR clients appeared willing to apply the threat of peer pressure to members to encourage repayment (called “ex ante pressure”), but were less inclined to follow through with social sanctions after a delinquency or default occurred (called “ex post pressure”). Unlike BRAC’s clients, there seemed little interest in punitive measures. As one neighborhood member explained, “We may sometimes feel angry, but we will never pressure other members so as not to ruin the neighborhood peace.”<sup>88</sup>

Paxton’s research has identified another destabilizing component in the peer mechanism. She labels it the “matching problem,” which describes the decreasing likelihood of a common interest among group members for similar size loans and terms. In short, at the first round, all those who receive a loan do so because they have expressed a loan need, and have self-selected into a group of like-minded individuals seeking the same type of loan product. At the second round, when they qualify for a larger loan, not all may need or want the same amount or want it at the same time. However, if four of the five do, the fifth may go along, “if he/she is indifferent. As more indifferent people are carried along with the process, the problem of arrears is exacerbated as individual needs are not matched to the loan sizes and terms.” In this scenario, higher arrears rates corresponded with the number of loan cycles a group had experienced.<sup>89</sup> Obviously, this dynamic is closely associated with a microfinance institution’s loan policies. Those that allow for flexibility in amount, and sometimes on participation (some village bank programs allow members to sit out a cycle of borrowing), would avoid this dynamic.

Finally, Paxton identified three factors that seemed to correlate with better repayment performance:

- **The nature of the participants:** In Burkina Faso, market women made the best borrowers and group members; they were familiar with group activity due to their participation in ROSCAs, and they understood how financial services worked;

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<sup>87</sup> Paxton and Fruman, 1997, p. 15. The authors also cite works by M. Braden (1986, “Financing Smallholder Production: A Comparison of Individual and Group Credit Schemes in Zimbabwe,” *Public Administration and Development* [6]) and T. Besley and S. Coate (1993, “Group Lending, Repayment Incentives and Social Collateral,” Princeton, NJ: Woodrow Wilson School of Public and International Affairs, Princeton University) that discuss the domino effect on theoretical and empirical levels.

<sup>88</sup> Paxton and Fruman, 1997, p. 16.

<sup>89</sup> Ibid., p. 17. See also Julia Paxton, 1996, “Determinants of Successful Group Loan Repayment: An Application to Burkina Faso,” Unpublished dissertation, The Ohio State University.

- **The group's exposure to training and leadership:** As might be expected from the theory of social intermediation, where groups had been exposed to detailed training, and worked closely with promoters in deciding on the rules of the game, the process worked better. Paxton and Fruman cite the village of Madougou as an example, where the bank agent worked closely with the village committee in establishing lending rules, and where the committee in turn played a large role in educating the entire village. "When interviewing groups in Madougou, each had contingency plans to repay in case of sickness, travel, or other reasons. This type of planning was not evident in Banh, a village characterized by widespread default;" and
- **The existence of other informal credit contracts:** These were normally from other family members and deemed "an indication of creditworthiness rather than having obligations spread too thin."<sup>90</sup>

The conclusion that appears warranted from these cases is that the effectiveness of the peer mechanism in ensuring repayment cannot be presumed. Much of its impact (positive or negative) depends on the details of how it operates, particularly in relationship to higher group structures in tiered systems, as well as in the way the program itself promotes these groups, and establishes and enforces ground rules. As Susan Johnson and Ben Rogaly comment: "Groups have been a common component of methodologies for lending to the poor but repayment does not solely depend on peer pressure; groups take different forms in different contexts and it is important to analyze the mix of circumstances which ensure repayment. This mix goes beyond peer pressure to include supervision, management, transparency, and accountability of the systems."<sup>91</sup>

Additional studies of these dynamics, in non-Bangladeshi contexts, would be welcome additions to the literature, and might offer better guidance to program designers and implementers about the value of this important element. When the group is not serving the function of supporting joint liability, does it offer other benefits in loan screening and administrative streamlining that cannot be better managed through other means?

### **Building Local Organizations: What Mechanisms Encourage Strong Accountability and Control?**

Those social intermediation strategies that aim to build grassroots structures at the farthest end of the participation continuum, in which participants are managers and not just clients, find it a challenging proposition. As Goldberg and Hunte report, groups do not innately know how to craft the most effective methods of organization:

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<sup>90</sup> Ibid., p. 17.

<sup>91</sup> Johnson and Rogaly, 1997, p. 56.

Without adequate exposure to new ideas from the NGO extensionist, a group develops its own “rules of the game” based on extremely limited experience. Group leaders draw on existing local financial services arrangements, such as moneylenders, family loans, supplier credit and ROSCAs. Groups may replicate the very features of existing systems which do not meet their needs. These problems may be reinforced by the group’s relationship with the NGO and internal dynamics.

There is a broad range of potential problems for groups which receive little guidance from NGO staff... groups set all loan terms themselves, and do not establish clear loan contracts with fixed repayment schedules...since many group members often have investments with similar characteristics and requirements, a crisis for one can become a crisis for all. Groups also...cannot differentiate between willful and unwillful defaulters. In sum, groups solve problems through ad hoc means unless NGO extensionists provide examples of transparent, effective systems for reaching decisions.

There are two reasons for the lack of guidance on financial services design and delivery: (i) the very limited financial experience of NGO extensionists and other staff and (ii) a conscious decision by NGO management to let groups make all key decisions alone. The emphasis on a highly participatory approach is laudable. However, the result is that groups have to learn many basic lessons for themselves, instead of taking advantage of the experiences of other groups and programs.<sup>92</sup>

An excellent example of this challenge — of supporting local autonomy and participatory financial services models — can be seen in the practice of village banking, where local community banks are expected to draw up their own by-laws for the management of both loan funds provided by the program (called the external account), as well as loan funds generated by members’ savings, fees, and interest income (called the internal account). Nelson and others (1996) identified three issues that affect a bank’s ability to realize the vision of a strong and stable, self-managed community finance institution: the quality of the leadership, the stability of the membership, and the effectiveness of the management control system. With respect to each of these, they report:

- “Building strong leadership has been more challenging, requiring more time and energy, than originally anticipated.” This is due to low levels of literacy on the part of clients, mostly poor women, who are expected to fill management roles in the bank. This in turn hampers leadership rotation, and makes the banks vulnerable to “caudillo-like” leadership, personalism and sometimes fraud.
- Membership turnover affects solidarity, stability of the banks, and the pace at which assets can accumulate. Some members exit definitively; others participate intermittently depending on their seasonal credit needs. “Balancing member attrition are huge waiting lists to join village banks. The persistent strong demand for village bank services explains the growth in the size of banks despite turn-over.” But it means that training and technical assistance need to be on-going rather than only at the initiation of bank operations.

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<sup>92</sup> Bennett, Goldberg, and Hunte, 1995, pp. 10-11.

- Banks need to monitor loans made from the external account, as well as develop, manage, and monitor an investment strategy for the use of internal account funds. “The greater the internal investment activity, the greater are the demands on village bank management. This requires financial and organizational skills, more sophisticated accounting systems, and an increased need for ensuring the transparency of operating systems.”<sup>93</sup>

Yet, internal account policies and management, record keeping, internal controls and security measures, were originally left largely in the hands of the banks themselves. This was thought to “generate a stronger sense of ownership and solidarity among the membership, as well as increase their management skills.”<sup>94</sup> In fact, in many cases, the opposite resulted with lack of transparency to members and implementing agency prevailing, and with external account loans and members’ savings placed at higher risk. Now, village bank practitioners have moved away from this posture of letting a thousand flowers bloom in terms of bank-level policies and practices. But finding a middle ground where risk is well managed, and yet appropriate adaptation to specific community needs is facilitated, is not an easy proposition. Members of SEEP’s Poverty Lending Working Group are now in the process of collecting examples of “better practice” in internal account management that would serve practitioners world-wide.<sup>95</sup>

In addition to these efforts, practitioners have introduced literacy and numeracy training into programs, strengthened start-up and ongoing training, facilitated leaders’ forums among bank management, and developed greater monitoring procedures. But all of this is not without cost. Again, Goldberg and Hunte report, “The use of groups does not guarantee cost savings to the NGO.”<sup>96</sup> This does not mean that better performing group models are out of financial range of individual models, but they are certainly not *more* cost-effective. And confronting organizational development issues such as the ones outlined here means that practitioners have a very fine line to walk with respect to costs.

### **Intermediation Models: To What Extent Do They Empower Participants?**

The strongest argument for social intermediation strategies is that they not only create mechanisms for the intermediation of financial resources, but they also empower the more disenfranchised citizens by building local organizations that can serve local needs, increase local control, and advance social as well as economic development.

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<sup>93</sup> Nelson and others, 1996, pp. 46-49.

<sup>94</sup> Judy Painter and Members of the SEEP Poverty Lending Working Group, 1997, *Internal Account Management Tool Kit* (draft).

<sup>95</sup> Ibid. This manual is being designed and tested with the support of the Microenterprise Best Practices Project Grant Facility.

<sup>96</sup> Bennett, Goldberg, and Hunte, 1995, p. 9.



A variety of authors support this argument. Nelson and others (1996), reviewing the results of a series of program-level impact assessments, found a significant body of self-reported data reflecting participants' changed perceptions of themselves, and changed behaviors.<sup>97</sup> One of the most well-developed studies of these effects is that of Sidney Schuler and Syed M. Hashemi, which examined the effect of both BRAC's and Grameen's program on women's empowerment and contraceptive use.<sup>98</sup> Using longitudinal survey data with a comparison group and ethnographic research, the investigators concluded the programs did indeed appear to increase women's levels of empowerment in statistically significant ways, both by strengthening their economic roles and by other program aspects. The authors found that this empowerment also led to greater contraceptive use by Grameen participants because of the emphasis on family planning norms included in their 16 Decisions (keep families small). Berenbach and Guzman also comment on the large number of primary schools that have been built by Grameen groups, and on their effect on women. As of June 1988, these schools were attended by 1,137,270 students, of whom 72 percent were female. As they note, "This is a remarkable achievement in a Moslem culture where female literacy is below 20 percent."<sup>99</sup>

Other authors are less sanguine about the strength of the empowerment process for women. Looking at Bangladesh again, Hulme and Mosley concur that both BRAC and Grameen have had great success in breaking down poor women's isolation. But, they scoffed at as "naive" the belief that every loan to a woman contributes to the strengthening of her position. They cite research that some 39 percent of the loans of Grameen Bank, BRAC, Proshika, and the Bangladesh Rural Development Bank (BRDB) are either fully or significantly controlled by men.<sup>100</sup> Where women do control their loans, they are for more traditional women's activities, such as livestock and poultry. They summarize: "Such high levels of male appropriation of female loans led Goetz and Gupta to conclude that 'gender relations and the household are in effect absorbing the high enforcement costs of lending to men in Bangladesh's rural credit system because women have taken over the task of securing loan repayments from their male relatives.'" Only divorced, separated, and widowed women appear to have gained greater control of their loans (55 percent compared with 18 percent for women overall).<sup>101</sup>

Given this contradictory evidence, at least in the Bangladesh setting, Hulme and Mosley conclude that women's empowerment in group-based programs cannot be taken for granted: "Programmes that genuinely seek to empower women will need to research loan usage much more carefully and will need to place a greater emphasis on developing new and more productive economic roles for women. A simple

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<sup>97</sup>Nelson and others, 1996, pp 64-65. The sample sizes for all these evaluations were small, ranging between 50 and 68. The positive outcomes ranged between 51 and 93 percent. The findings are, therefore, indicative rather than definitive.

<sup>98</sup> Hashemi and Schuler, 1994, pp. 66-67.

<sup>99</sup> Berenbach and Guzman, 1992, p. 62.

<sup>100</sup>The authors cite A. M. Goetz and R.S. Gupta, 1994, "Who Takes the Credit? Gender, Power and Control over Loan Use in Rural Credit Programs in Bangladesh," IDS Working Paper No. 8, Brighton: Institute of Development Studies at the University of Sussex.

<sup>101</sup> Hulme and Mosley, Volume 1, 1996, p. 128.

emphasis on disbursing to women is likely to encourage tokenism and the reinforcement of established gender roles. . . .”<sup>102</sup>

They also advise that programs need to pay attention to which women are empowered, because their investigation of BRAC groups found that the women who received the greater benefits were likely to be the ones that were already “empowered vis-à-vis other (less-well-off) women, rather than vis-à-vis the menfolk in their household (or in wider society). . . . So agencies need to pay much greater attention to their capacity to assist target groups within the female population (particularly the assetless, widowed and divorced) rather than treating women as a homogenous group.”<sup>103</sup>

### **Group Members: Why Do They Drop Out?**

Membership fluctuations present real costs and challenges for social intermediation programs. Membership turnover results in leadership gaps, higher ongoing recruitment, screening, and training costs, and other management challenges. Despite the benefits ascribed to group membership, the phenomenon of dropping out is widespread. Hulme and Mosley report that 15 percent of Grameen’s membership drops out annually, which is 300,000 members a year. For BRAC, the figures were 10 and 15 percent for 1992 and 1993, respectively, or around 181,000 members. The authors suggest that these rates may be related to credit-induced crises suffered by the most vulnerable, as discussed above.<sup>104</sup>

Other programs also have experienced significant dropout rates. Berenbach and Guzman, in discussing solidarity group lending programs associated with ACCION affiliates, also confirm that “a significant share of participants. . . drop out from the programs altogether.” They cite as an example the case of Colombia’s Association for Solidarity Groups, from which a full 38 percent were reported to have withdrawn as of 1992. One quarter of these departures have been attributed to repayment problems; others, however, have left after satisfactorily completing their debt obligations.<sup>105</sup>

SEEP’s Poverty Lending Working Group has collected data on a sample of village banks from programs around the world, and found that the range of dropout varies but is considerable around the world. Loan ledger data from seven programs in Africa and Latin America revealed that the number of founding members participating throughout the life of the banks ranged from 13 to 61 percent. Rural banks seemed to maintain their membership longer; excluding them, retention rates ranged between 13 and 43 percent. Turnover appeared higher in the earlier cycles when clients were still discovering the implications of program participation in terms of time commitments, repayment discipline, and joint liability, after which membership tended to stabilize more.

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<sup>102</sup> Ibid., p. 129.

<sup>103</sup> Ibid.

<sup>104</sup> Ibid., p. 122.

<sup>105</sup> Berenbach and Guzman, p. 72.

Other reasons have also been cited for attrition: some departures relate to seasonal demands of agriculture, and clients seek to leave and then rejoin programs; other reasons relate to illnesses, employment opportunities, relocation, and program dissatisfaction. Members also leave for poor performance, either selecting out themselves or being requested to leave by other members. The percentage of clients departing for these reasons varies from program to program.<sup>106</sup>

In looking at this problem in 1992, Berenbach and Guzman commented:

Further research is needed to determine to what extent dropouts who leave with a satisfactory credit history are in effect graduates who have built up sufficient internal working capital to satisfy their businesses' operating and growth requirements; have successfully secured financing at more attractive terms from savings and loan cooperatives, suppliers, or other commercial sources; or have simply gotten another job or moved away. To the extent that there are graduates from these microcredit SGPs, this would be an indication of the programs' strength. On the other hand, dropouts, when associated with business failures, demonstrate the vulnerable personal and business situation of a significant share of the program clients; this attrition represents a significant loss for borrowers and for programs (pp. 72-73).

In fact, since that statement was written, many programs have come to view client dropouts as a significant loss for programs, whether the outcome is good or bad for the clients themselves. As programs push towards scale and self-sufficiency, they see any client attrition as having serious cost implications. New clients are always more expensive to manage than experienced clients; they take smaller-sized loans, which cost more to administer and contribute less to revenues; and they have not proven their trustworthiness. Also, if longer program participation is associated with greater impact, then early departures may not have obtained the fullest amount of benefit from the program. ACCION has come to look at the issue as one that requires market research: What do we know about our clients and their needs? To what extent do programs try to sell a product they believe the clients need instead of continuously determining what the needs are, and attempting to design services that meet them.

While individual-based credit programs may have similar issues, the impact on group-based lending programs is more severe, because each loss impacts the dynamics of a whole group of people. And, although part of the answer may lie in better marketing research and part in continual training for groups, much more needs to be understood for programs to develop the right, cost-effective responses to this reality.

### **How Critical Is the Group in Effective Microfinance?**

Depending on one's point of view, the necessity of group-based lending—the essence of social intermediation—remains open to debate. Observers who view the *raison d'être* of microfinance to be financial intermediation sense that well-structured individual schemes may provide just as satisfactory a result in scale, a high level of self-sufficiency, and outreach to the poor, if not the poorest. Again, Hulme

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<sup>106</sup> Presentation by Rosemary Pugh, FINCA, at the SEEP Annual Meeting, October 1997.

and Mosley raise some serious issues. Based on their studies, they assert that “the organization of borrowers in groups is neither necessary nor sufficient for success,” and they cite as evidence the examples of successful Indonesian individually oriented lending schemes (BRI, BKK, and KURKs), and unsuccessful Malawian group-based schemes (Mudzi Fund and the Smallholder Agricultural Credit Administration program).<sup>107</sup>

Instead, the authors propose the following set of design features as the critical ones: intensive loan collection, the existence of savings and insurance facilities, and incentives to repay.<sup>108</sup> They further believe that the poverty impact of programs can be increased by the adoption of any of the following features not already included in their methodologies:

- Mobile banking;
- Emergency consumption loans;
- Tapered interest rates differentiated according to the administrative cost and size of the loan (that is, with a higher rate for the smallest size loans);
- Salary incentives for staff linked to financial performance; and interest rate incentives for borrowers, based on their repayment performance; and
- Drought insurance schemes in agricultural lending programs.<sup>109</sup>

Those, however, who are concerned not just with issues of financial access, but also with issues of social development, and in particular the building of autonomous, self-reliant organizational structures owned and managed by the poor, stress the role that social intermediation plays in bringing this about. The fact that such systems also appear to have the advantage of outreach to the more remote areas, and can do so in a cost-effective way, is sufficient demonstration of the added value that group-based programs can provide. As Bennett suggests (1996b),

It is true that some of the outcomes of building social capital are a bit “fuzzy.” The solidarity and trust that grows between members of the SHG over time, the self-confidence that women gain from their savings, their wider exposure through the group, their ability to speak out as a group against domestic violence and alcoholism among their menfolk: these are difficult to measure even though the difference they make is clearly evident. But the ability of the SHG to create an “information asset” for its members in the form of a credit history, is a very concrete manifestation of social capital. The building of a local level informal financial intermediary and the transfer of skills needed to keep accounts, enables formal financial institutions to get the information they require to assess the credit-

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<sup>107</sup> Hulme and Mosley, Volume 1, 1996, p. 55.

<sup>108</sup> Ibid., pp. 24-30, 55.

<sup>109</sup> Ibid., p. 202.

worthiness of these poor women. The social capital created by the SHG lowers the transactions costs to the bank of doing business with SHG members. In a very concrete way, it is creating the basis for *trust* between the banker and low income, illiterate clients and thus, helping to integrate these clients into the formal financial market. (p. 6.)

## RECOMMENDATIONS FOR FUTURE RESEARCH

This literature review has attempted to present both the conceptual underpinnings of social intermediation in microfinance programs, and an overview of the experience of a range of programs employing these strategies. It also identified a set of critical issues that either illuminate differences between goals and outcomes, or that require further research and testing of methods.

As indicated in the introduction, this review has identified significant gaps in the literature for this topic. Very few works are directed to social intermediation as the principal source of inquiry. Further, there is a heavy reliance on the Bangladesh experience in much of what has been written. Although this makes sense historically, given the pioneering role of the Grameen Bank and other practitioners there, the application of social intermediation techniques around the world calls for a wider examination of many of the critical issues this document has identified. Three areas warrant additional research:

- **Client Dynamics:** In 1986, Otero wrote: “While much has been written and documented about the SGPs and their social and economic impact on micro-entrepreneurs, we still know very little about the internal workings of the solidarity groups themselves. What emerges from the available data and project experiences is a general understanding of how solidarity groups are formed and the characteristics they have in common.”<sup>110</sup> In 1996, Hulme and Mosley have written: “In practice, very little is known about intra-group processes and the relative significance of positive (that is supportive) and negative (punitive) action in contributing to repayment in unclear. Our research pointed to the complexity of such processes and the need for further work that focuses exclusively on this issue.”<sup>111</sup>

This paper has summarized the small body of research that considers group member attitudes and behaviors vis-à-vis self-selection, and the joint liability mechanism. But much more needs to be extracted from a variety of contexts and structures (solidarity group programs with second-tier centers, solidarity group programs without, village banks, and cooperatives) to better understand which structural elements enhance the peer mechanism and which undermine it. Because it appears that institutional culture also has a strong effect on how promoters implement group-level policies, that aspect also needs to be analyzed as well. Most importantly, such research needs to directly incorporate borrower perspectives on the group process. In this respect, a comparative, field-based inquiry interviewing group members, documenting group histories, and joining these with staff insights would be a welcome addition to the literature.

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<sup>110</sup> Otero, 1986, p. 37.

<sup>111</sup> Hulme and Mosley, 1996, p. 170.

- **Training and Technical Assistance:** The development of client skills to manage credit and savings activities, and to develop strong local organizations, is integral to social intermediation. Yet, there is no comparative documentation of the training and technical assistance methods (and materials) used, or ready answers to the following questions. What is common in the organizational development processes used? How much training is enough? What is required at start-up and over time? What are initiation and recurrent costs for carrying it out? A number of the cases reviewed for this paper identified as having difficulties were also identified with lapses in group formation and organizational development assistance. What is best practice in these regards for solidarity groups, for village banks, for self-help groups and cooperatives? Are there lessons that can be shared across methodologies as well?
- **Linking Models:** Although Bennett, Harper (1996), and others cite some benefits from the linking approach, and believe that there are contexts in which it is appropriate, there is little detailed documentation of how this strategy works, and of successful cases using it.<sup>112</sup> If this is, indeed, a legitimate avenue for social intermediation, especially for NGOs that wish to avoid handling the financial transaction, then more research appears required to demonstrate the viability of this approach, and what best practice looks like.

In reviewing this literature, the contributions that the World Bank's Sustainable Banking for the Poor project has made to the understanding of social intermediation are evident. Their work continues with the documentation of several case studies around the world. However, the detailed workings of these approaches need greater illumination, and the perspectives of the clients themselves need greater articulation. It is recommended that other researchers build on the base that the Bank has laid, and move this analysis forward with a worldwide perspective, so that practice moves forward on a sounder base of knowledge and experience.

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<sup>112</sup> Bennett, forthcoming, edited by Von Pischke, p. 10; Bennett, 1996a, p. 6; Harper, 1996, pp. 37-38.

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